TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1928 29

No. ~~846~~ 67

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

AMERICAN CODE COMPANY, INCORPORATED

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 19, 1929
CERTIORARI GRANTED MAY 20, 1929

(34155)

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1928

No. ——

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

AMERICAN CODE COMPANY, INCORPORATED

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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1 Before United States Board of Tax Appeals

AMERICAN CODE COMPANY, INC., PETITIONER
vs.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
} Docket No. 9077

For taxpayer, Clark H. Hebner, Esq.
For commissioner, Bruce A. Low, Esq.

Docket entries

1925

Nov. 13 Petition received and filed.
" 19 Copy of petition served on solicitor.
" 19 Notification of receipt mailed taxpayer.
Dec. 10 Answer filed by solicitor.
" 12 Copy of answer served on taxpayer—assigned to general calendar.

1926

Nov. 24 Hearing date 2-3-27.

1927

Feb. 3 Hearing had before Mr. Phillips on merits—briefs due 5-3-27.
Feb. 7 Transcript of hearing of 2-3-27 filed.
Apr. 30 Brief filed by taxpayer.
" 30 Proposed findings of fact filed by taxpayer.

2

1928

Feb. 2 Findings of fact and opinion rendered—Mr. Phillips. Decision will be entered for the respondent.
" 28 Order of redetermination entered.
June 7 Petition for review by U. S. Cir. Ct. of Appeals, 2nd Cir., with assignment of errors, filed by taxpayer.
" 7 Proof of service filed by taxpayer.
" 7 Præcipe of record with proof or service filed by taxpayer.
July 27 Transcript of record sur petition for review sent U. S. Cir. Ct. of Appeals, 2nd Cir.

Now, July 25, 1928, the foregoing docket entries certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

3 **Before United States Board of Tax Appeals**

[Title omitted.]

Petition

The above-named taxpayer hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his deficiency letter (IT:CA-2111-8-60-D) dated September 17, 1925 (the date of the mailing of which letter is unknown to the taxpayer), and as the basis of its appeal sets forth the following:

1. The taxpayer is a corporation duly incorporated under and by virtue of the laws of the State of New York, having its principal office and place of business at No. 206-208 Broadway, in the Borough of Manhattan, city, county, and State of New York.

2. The deficiency letter was dated September 17, 1925, the date of the mailing of the letter to the taxpayer being unknown.

3. The tax in controversy is income tax for the calendar year
4 1919, the amount of the deficiency tax proposed to be assessed being the sum of $122.91, the taxpayer, however, claiming to be entitled to a refund of $9,365.11, the original claim for refund in the sum of $10,036.79 having been reduced by reason of adjustments in items of the 1919 return made by the bureau and not contested by the taxpayer.

4. The determination of tax contained in such deficiency letter and the rejection of the taxpayer's claim for refund is based upon the following error:

In determining the taxpayer's net income for the year 1919 the Income Tax Unit has disallowed a deduction claimed by the taxpayer of a loss or liability which accrued in 1919, in the sum of $21,019.19, such sum representing the amount of a judgment rendered against the taxpayer in the Supreme Court of the State of New York in January, 1922, affirmed on appeal in 1923, and paid in 1923, but being the result of a suit for damages against the taxpayer begun in 1919 under a contract made and breached by the taxpayer in 1919, the disallowance of such deduction resulting in the rejection of the taxpayer's claim for refund and the proposed additional tax in the sum of $122.91.

5. The facts upon which the taxpayer relies as the basis of its appeal are as follows:

On the 3rd day of January, 1919, the taxpayer entered into a contract with one Cosmo Farquhar under and by virtue of which
5 the taxpayer agreed to employ said Farquhar as its sales manager for a term of years to end on February 1, 1937, Farquhar to be compensated for his services by the payment by the taxpayer of certain commissions based upon gross receipts from sales. The employment was entered into under the contract and continued until

May 1, 1919, when the taxpayer discharged said Farquhar and refused to continue him in its employ. In July, 1919, Farquhar brought suit against the taxpayer in the Supreme Court of New York County to recover damages for the taxpayer's breach of said contract of employment. The said suit was not reached for trial in its regular course upon the court calendar of said court until January 9, 1922. The trial was completed on January 10, 1922, and resulted in a verdict by the jury in favor of said Farquhar against the taxpayer in the sum of $21,019.19. The taxpayer appealed from said verdict to the appellate division of the supreme court, which appellate court affirmed the judgment. Further appeal was then taken by the taxpayer to the Court of Appeals of the State of New York, which court also in 1923 affirmed the said judgment, whereupon the taxpayer paid the same.

Meanwhile and on October 28, 1919, the taxpayer communicated with the Treasury Department, requesting that it issue a ruling allowing the taxpayer in making its income-tax return for 1919 to deduct the approximate amount of the taxpayer's liability on account of such breach of contract. On November 11, 1919, the Treasury Department, in a communication to the taxpayer, rules that
6 the deduction could not be claimed as a deduction from gross income in 1919. Nevertheless the taxpayer actually set up on its books as a liability for the year 1919, and for each subsequent year until actual payment was made, an amount to cover such liability. On January 21, 1925, the taxpayer prepared and filed with the Treasury Department a claim for refund on account of the 1919 taxes in the sum of $10,036.79, alleging that the income for that year had been reduced by $21,019.19, representing the judgment paid in 1923, but chargeable to income for 1919, the year in which the liability was actually incurred. Income and profits tax waiver for the year 1919 was duly executed and filed with the Treasury Department on or about November 26, 1924, extending until March 15, 1926, the time within which to determine a deficiency or other adjustment of tax.

6. The taxpayer in support of this appeal relies upon the following propositions of law:

(a) Section 234 of the revenue act of 1918 allows to a corporation as a deduction from gross income losses sustained during the taxable year not compensated for by insurance or otherwise.

(b) Regulation 45, article 111, allows a taxpayer making returns on an accrual basis to deduct all authorized allowances, whether paid in cash or set up as a liability.

(c) A taxpayer's liability for damage on account of his breach of contract is a damage and loss actually incurred at the date of the breach.

7 7. Annexed hereto is a copy of the letter of the Commissioner of Internal Revenue advising the taxpayer of determination of deficiency tax.

Wherefore the taxpayer respectfully prays that this board may herein determine its appeal.

(Signed) CLARK H. HEBNER,
Counsel for Taxpayer,
No. 50 Broad Street, Borough of Manhattan, New York City.

[*Duly sworn to by Cyrus F. Tibbals; jurat omitted in printing.*]

8 EXHIBIT TO PETITION

Address reply to Commissioner of Internal Revenue and refer to IT:CA–2111–8–60–D.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, Sept. 17, 1925.

AMERICAN CODE COMPANY,
206 Broadway, New York, New York.

SIRS: The determination of your income-tax liability for the years 1919 to 1921, inclusive, pursuant to an examination of your books of accounts and records, as set forth in office letter dated July 31, 1925, has been changed as a result of your letter of August 22, 1925, to disclose a deficiency in tax amounting to $122.91 for 1919 and an overassessment amounting to $45.74 for 1920, and no change for 1921, as shown in the attached statement.

In accordance with the provisions of section 274 of the revenue act of 1924 you are allowed 60 days from the date of mailing of
9 this letter within which to file an appeal to the United States Board of Tax Appeals contesting in whole or in part the correctness of this determination.

Where a taxpayer has been given an opportunity to appeal to the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement in respect of any part of the deficiency will be entertained.

If you acquiesce in this determination and do not desire to file an appeal, you are requested to sign the inclosed agreement consenting to the assessment of the deficiency and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT: CA–2111–8–60–D. In the event that you acquiesce in a part of the determination, the agreement should be executed with respect to the items agreed to.

Respectfully,

D. H. BLAIR, *Commissioner.*
By J. G. BRIGHT, *Deputy Commissioner.*

Inclosures: Statements; agreement, Form A.

10 STATEMENT

IT:CA-2111-8-60-D.

In re American Code Company, 206 Broadway, New York, New York.

DEFICIENCY IN TAX OVERASSESSMENT

1919	$122.91
1920	$45.74
1921	

1919—NET INCOME

Net income reported	$39,746.08
Add: Inventory adjustment in accordance with taxpayer's letter of August 22, 1925	267.20
Net income revised	40,013.28

INVESTED CAPITAL

Capital stock	$100,000.00	
Less: Treasury stock	38,800.00	
		$61,200.00
Paid-in surplus		14,375.00
Reserve		2,310.15
Total		77,885.15
11 Deduct: Intangibles as reported on return		51,911.68
Invested capital revised		25,973.47

TAX

Profits tax as limited under section 302	$11,405.31
Amount of 10% income tax	2,651.56
Total tax assessable	14,056.87
Tax previously assessed	13,933.96
Deficiency in tax	122.91

STATEMENT

In re American Code Company.

1920—NET INCOME

Net income in accordance with taxpayer's letter of August 22, 1925	$31,243.98

TAX

Profits tax as limited under section 302	$7,897.59
Amount of 10% income tax	2,085.14
Total tax assessable	9,982.73
Tax previously assessed	10,028.47
Overassessment	45.74

Your claim for refund of $10,036.79, income and profits tax for 1919, has been examined and will be rejected in full for the reason that the audit as shown in the above computation discloses a tax in addition to the amount previously assessed.

Your claim for refund of $861.12, income and profits tax for 1920, has been examined and will be allowed for $45.74 and rejected for $815.38, in accordance with the above computation.

Compilations are considered analogous to secret processes, formulæ, etc., inasmuch as the income derived therefrom is contingent on the preparation thereof.

It is also considered that the compilations and copyrights are intangible assets for the reason that their value is contingent upon and measured by their earning power. This is supported by your contention that prior to 1914 each individual owner earned a minimum of $10,000.00 per annum from the assets turned over to the corporation at the date of incorporation.

It is therefore held that the value of $200,000.00 placed on the book plates, compilations, and copyrights prior to the enactment of the excess profits tax be allowed for depreciation purposes only and that in computing invested capital the limitations for intangibles be applied.

The deduction of $21,019.19 claimed for 1919, representing the amount of a judgment rendered through a damage suit decided in 1923 and paid in 1923, which was based upon a contract entered into in 1919, cannot be allowed as a deduction in 1919. The decision referred to in your brief has not been acquiesced in by the commissioner.

The inventory adjustments have been allowed in accordance with your letter of August 22, 1925.

The right of appeal as indicated on page one of this letter refers only to any deficiency in tax indicated herein, inasmuch as there is no provision in the revenue act of 1924 granting the right of appeal against the determination of any overassessment found upon an audit of your returns.

Now, July 25, 1928, the foregoing petition certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Before United States Board of Tax Appeals

[Title omitted.]

Answer

The Commissioner of Internal Revenue, by his attorney, A. W. Gregg, Solicitor of Internal Revenue, for answer to the petition of the above-named taxpayer, filed November 13, 1925, admits and denies as follows:

1. Admits the statements and allegations contained in the introductory paragraph and paragraphs numbered 1 and 2.

2. Admits that the tax in controversy is income tax for the calendar year 1921, in the sum of $122.91.

3. Admits all the material facts relevant to the issues herein involved alleged in paragraph 5 of taxpayer's petition except the following statement: "Nevertheless the taxpayer actually set up on his books as liability for 1919 and for each subsequent year until actual payment was made, an amount to cover such liability."

4. Denies that the damages for which the taxpayer became liable on account of the breach of contract with Cosmo Farquar, and for which reserves are alleged by the taxpayer to have been set up, were actually incurred in 1919.

5. Denies that the taxpayer set up on his books in 1919 a reserve in an amount approximately equal to a judgment rendered against it in 1923, or set up on its books reserves in 1919 in any sum.

6. Denies generally and specifically each and every allegation of taxpayer's petition not hereinbefore admitted, qualified, or denied.

PROPOSITION OF LAW

Only liabilities accruing at the time of the breach of contract which can be determined with approximate accuracy, and are so determined, as shown by evidence and are set up as liabilities for the year can be deducted from gross income of the year in question.

Wherefore it is prayed that the taxpayer's appeal be denied.

A. W. GREGG,
Solicitor of Internal Revenue,
Attorney for Commissioner of Internal Revenue.

Of counsel:
BRUCE A. LOW,
Special Attorney,
Bureau of Internal Revenue.

Now, July 25, 1928, the foregoing answer certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

16 Before United States Board of Tax Appeals

[Title omitted.]

Findings of fact and opinion

Feb. 2, 1928

The petitioner at the close of the taxable year set up on its books as a reserve for the breach of a contract of employment the amount which would have become due under such contract as commissions

had there been no breach. At that time the employee was suing for damages for the breach of such contract and the petitioner had denied any liability. The amount of the liability was not determined until a subsequent year. Held, that the petitioner was not entitled to deduct in the taxable year the amount so set up as a reserve.

Clark H. Hebner, Esq., for the petitioner.

Bruce A. Low, Esq., for the respondent.

The commissioner determined a deficiency of $122.91 in income and profits taxes of the petitioner for 1919. The petitioner seeks
17 a redetermination of such deficiency, alleging that it has made an overpayment of its taxes for such year in the amount of $9,365.11. The petition alleges that the commissioner committed error in refusing to allow the deduction of a loss alleged to have occurred in 1919 upon breach of a contract.

FINDINGS OF FACT

The petitioner is a New York corporation, organized in the year 1914 in the Borough of Manhattan of the city of New York.

On January 3, 1919, the petitioner entered into a contract of employment with one Cosmo Farquhar for a term to begin on January 3, 1919, and to end on February 1, 1937, the compensation of the employee to be a commission based upon the sales made in the petitioner's business.

On May 1, 1919, the petitioner discharged the said Cosmo Farquhar from its employ.

In July, 1919, Farquhar began action against the taxpayer in the Supreme Court of New York County to recover commissions due him for April, 1919, alleged to be $100, and for berach of the contract of employment, claiming damages for such breach in the amount of $100,000. The petitioner defended such action on the ground that Farquhar had previously breached his contract of employment and that his discharge was justified by reason of his failure to perform his duties. This action was reached for trial in January, 1922, and resulted in a verdict by the jury against the petitioner and an award of damages in favor of Farquhar for breach of contract in the sum of $21,019.19.

18 The petitioner appealed to the appellate division of the supreme court, State of New York, which court, on June 2, 1922, affirmed the judgment. Petitioner then appealed to the Court of Appeals of the State of New York, in which court the judgment was again affirmed on the 16th day of January, 1923.

The petitioner paid the amount of said judgment in January, 1923.

The petitioner kept its books and made its income-tax returns on the accrual basis.

The petitioner, at the close of the year 1919, set up on its books as a reserve for the breach of the contract of employment the amount of $14,764.79, such amount having been computed at the rates of

commission and on the basis specified in the said contract. At the close of the year 1920 this reserve was increased on the petitioner's books by $32,994.09 to conform to the amount of its liability computed on the same basis, and at the close of the year 1921, judgment having been rendered early in January, 1922, before the books had been closed for 1921, the reserves so set up on its books, amounting to $47,458.88, was adjusted to the liability as fixed by the judgment against the petitioner in the sum of $21,019.19.

On October 28, 1919, the petitioner wrote the commissioner that its employee was suing to recover commissions due under the contract and made a written request of the Commissioner of Internal Revenue for permission to deduct from petitioner's income-tax return for 1919 the accumulated commissions which would be due on
19 December 31, 1919, under the contract, which request was denied on November 11, 1919.

The petitioner, in compliance with said ruling by the commissioner, did not deduct in its 1919 income-tax return the amount set up as a reserve for 1919 commissions, but on January 21, 1925, its 1919 return being then in process of audit by the Income Tax Bureau, the petitioner filed a claim for refund with the Commissioner of Internal Revenue, in which it claimed the right to deduct from its income for the year 1919 the amount of its liability for breach of the said contract of employment, the sum of $21,019.19, and that by reason of such deduction it was entitled to a refund of income tax paid for 1919 in the sum of $9,364.85.

The commissioner, in a notice dated September 17, 1925, rejected such claim for refund and asserted a deficiency in tax against the petitioner for 1919 of $122.91.

OPINION

PHILLIPS: The decision of this case appears to be controlled by the decision of this board in Hidalgo Steel Co. v. Commissioner (8 B. T. A. 76).

Further, it should be noted that in the present case the amount set up on the books of the petitioner on account of its liability was the amount becoming due to Farquhar under the terms of the agreement. The suit, however, was not for commissions due under the contract (except as to the month of April, 1919) but was for breach of the contract. While the amounts becoming due under the contract
20 would be one element to be considered by the jury in fixing damages for its breach, it was by no means the measure of the damages sustained. It seems clear that the amounts set up on the books in 1919 and 1920 were not considered to be for damages for breach, but were intended to and did represent the amount which would have been a liability had the contract continued in force.

Decision will be entered for the respondent.

Now, July 25, 1928, the foregoing findings of fact and opinion certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

21 Before United States Board of Tax Appeals

[Title omitted.]

Order of redetermination

Pursuant to the board's findings of fact and opinion, promulgated February 2, 1928, it is

Ordered and decided that, upon redetermination, there is a deficiency for the year 1919 in the amount of $122.91.

(Signed) PERCY W. PHILLIPS,
Member, United States Board of Tax Appeals.

Enter: Washington, D. C., Feb. 28, 1928.

Now, July 25, 1928, the foregoing order of redetermination certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

22 In United States Circuit Court of Appeals for the Second Circuit

AMERICAN CODE COMPANY, INC., PETITIONER,
vs.
DAVID H. BLAIR, COMMISSIONER OF INTERNAL REVENUE, respondent
No. 9077. Term, 1928.

Petition for the review of decision of the United States Board of Tax Appeals

To the honorable, the judges of the United States Circuit Court of Appeals for the Second Circuit:

Your petitioner, American Code Company, Inc., respectfully represents that it is, and was at all the times hereinafter mentioned, a corporation duly incorporated under the laws of the State of New York, having its office at No. 206 Broadway, Borough of Manhattan, New York City.

In support of this, its petition filed in pursuance of the provisions of section 1001 of the act of Congress approved February 26th, 1926, entitled the "Revenue act of 1926," for the review of the decision of the United States Board of Tax Appeals rendered on the 2d
23 day of February, 1928, approving a deficiency in income tax of the petitioner for the calendar year 1919 in the amount of $122.91, your petitioner respectfully shows to this honorable court, as follows:

I. STATEMENT OF THE NATURE OF THE CONTROVERSY

1. That on November 13th, 1925, the petitioner filed with the United States Board of Tax Appeals, in pursuance of the provisions of the revenue act of 1924, its petition requesting a redetermination of a deficiency in income taxes for the calendar year 1919, amounting to $122.91, as shown by the final notice of deficiency mailed by the respondent under date of September 17th, 1925, and the allowance of a refund to the petitioner of $9,365.11.

2. That the said petition alleged that on January 3d, 1919, the petitioner entered into a contract of employment with one Cosmo Farquar for a term of years to end on February 1st, 1937, under which Farquar was to be compensated for his services by the payment to him of certain commissions based upon gross receipts from sales; that on May 1st, 1919, said Farquar was discharged by the petitioner, and in July, 1919, brought action in the Supreme Court of the State of New York, New York County, against the petitioner to recover damages for a breach of the said contract of employment; that said action was not reached for trial in its regular course until
24 January 9th, 1922; that said trial resulted in a verdict by the jury in favor of said Farquar against the petitioner in the sum of $21,019.19; that the petitioner appealed from said verdict to the appellate division of the Supreme Court of the State of New York, which court affirmed the judgment; that the petitioner then appealed to the Court of Appeals of the State of New York, which court in 1923 also affirmed the said judgment, which was thereupon paid by the petitioner; that in October, 1919, the petitioner requested a ruling from the respondent allowing it to deduct the approximate amount of its liability, on account of the alleged breach of contract, in its return for the year 1919, which ruling was refused; that your petitioner, nevertheless, actually set up on its books for the year 1919, and for each subsequent year until actual payment was made, a reserve or estimated amount of its loss to cover such liability; that the petitioner kept its books and made its income tax returns on the accrual basis; that on November 26th, 1924, the petitioner duly executed and filed with the respondent an income and profits tax waiver for the year 1919 extending until March 15th, 1926, the time within which to determine a deficiency or other adjustment of tax; that on January 21st, 1925, your petitioner prepared and filed with the respondent a claim for refund on account of 1919 taxes in the sum of $10,036.79, alleging that the income for that year had been reduced by $21,019.19, the amount of the judgment for breach of contract paid in 1923, but chargeable to income for 1919, the
25 year in which, by reason of the breach, the liability was actually incurred; that by reason of adjustment of items of the 1919 return made by the respondent and not contested by the petitioner the original claim for refund was reduced to the sum of $9,365.11; that by the letter of determination dated September 17th, 1925, the respondent disallowed the petitioner's claim for refund

and claimed a deficiency in tax in the sum of $122.91, as hereinafter set forth.

3. That thereafter and on December 10th, 1925, respondent filed with the said board its answer to the said petition, which answer admitted that the petitioner was a corporation organized and existing under the laws of the State of New York, having its principal place of business at No. 206 Broadway, Borough of Manhattan, city of New York; that the respondent had mailed to the petitioner a notice of deficiency in the sum of $122.91 for the calendar year 1919; that all the material facts alleged in the petition were true except the statement that the taxpayer actually set up on its books as a liability for 1919 and for each subsequent year until actual payment was made an amount to cover such liability; but which answer denied that the damages for which the petitioner became liable and for which reserves were set up by the petitioner were actually incurred in 1919.

4. That the cause, being at issue under the rules and practice of said board upon the filing of such answer, duly came on for hearing
on February 3rd, 1927, at which time the petitioner by compe-
26 tent witnesses submitted testimony in support of the allega-
tions as aforesaid. Thereafter, on February 2nd, 1928, said board rendered its findings of fact, which were in substantial accordance with the facts as alleged in the petition, and as hereinbefore set forth, together with an opinion in which it was held (by reference therein to the previous decision of said board in Hidalgo Steel Company v. Commissioner, 8 B. T. A. 76) that the damages for the said breach of contract were not incurred in 1919, the year of the breach, and that decision should be entered for the respondent. On February 28th, 1928, the said board entered its final order of redetermination, approving the deficiency as determined by the respondent, in the amount of $122.91.

II. DESIGNATION OF COURT OF REVIEW

1. The petitioner, being aggrieved by the said opinion, decision, and order, and being a corporation with its principal place of business in the Borough of Manhattan, city of New York, desires a review thereof in accordance with the provisions of the revenue act of 1926 by the United States Circuit Court of Appeals for the Second Circuit, within which circuit is located the office of the collector of internal revenue to whom the petitioner made its income-tax returns.

III. ASSIGNMENT OF ERRORS

The petitioner, as a basis for review, makes the following assign-
ments of error:
27 1. The opinion of the Board of Tax Appeals is in error in
holding that the amount set up on the books of the petitioner for the years 1919 and 1920 were not considered to be for damages

for breach of contract, and such holding is not in accordance with but is contrary to the findings of fact made by said board.

2. The Board of Tax Appeals erred in holding (by reference to its previous decision in Hidalgo Steel Company v. Commissioner, 8 B. T. A. 76) that damages for breach of contract, not finally determined until a future year, are an allowable deduction in the year of the breach only in those cases in which admission of the liability is made during the year of the breach.

3. The Board of Tax Appeals erred in holding (by reference to its previous decision in Hidalgo Steel Company v. Commissioner, 8 B. T. A. 76) that denial by a taxpayer of liability for breach of contract by contesting such breach before the courts changes the date as of which the liability is incurred from the date of the breach to the date of payment of the damages as finally determined.

4. The Board of Tax Appeals erred in holding that the petitioner is not entitled to deduct from its 1919 income the damages sustained by it by reason of the breach of contract which occurred in that year.

5. The board erred in rendering decision for the respondent.

28 Wherefore your petitioner prays that this honorable court may review said decision, opinion, and order and reverse and set aside the same, and that the clerk of the United States Board of Tax Appeals be directed to transfer and deliver to the clerk of said court certified copies of all and every of the documents necessary and material to the presentation and consideration of the foregoing petition for review and as required by the rules of said court and statutes made and provided.

And your petitioner will ever pray.

AMERICAN CODE COMPANY, INC.,
By CYRUS F. TIBBALS, Jr.,
Vice President.

CLARK H. HEBNER,
Attorney for the Petitioner,
No. 21 East 40th Street, Manhattan, New York.

29 [*Duly sworn to by Cyrus F. Tibbals, jr.; jurat omitted in printing.*]

Now, July 25, 1928, the foregoing petition for review certified from the record as a true copy.

[SEAL.]

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

30 Before United States Board of Tax Appeals

[Title omitted.]

Præcipe

To the CLERK OF THE UNITED STATES BOARD OF TAX APPEALS.

You will please prepare and, within sixty days from the date of the filing of the petition for review in the above stated case, transmit to the clerk of the United States Circuit Court of Appeals for the Second Circuit certified copies of the following documents:

1. The docket entries of proceedings before the United States Board of Tax Appeals in the case above entitled.
2. Pleadings before the board.
3. Findings of fact, opinion, and decision of the board.
4. Petition for review.

31 The foregoing to be prepared, certified, and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Second Circuit.

(Signed) CLARK H. HEBNER,
Attorney for American Code Company, Inc.

JUNE 7TH, 1928.

Now, July 25, 1928, the foregoing præcipe certified from the record as a true copy.

[SEAL.] B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

(2412)

32 In United States Circuit Court of Appeals for the Second Circuit

No. 109, October term, 1928. Argued December 12, 1928. Decided January 14, 1929

AMERICAN CODE COMPANY, INC., PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

APPEAL from the United States Board of Tax Appeals.
Before MANTON, SWAN, and AUGUSTUS N. HAND, Circuit Judges.

Opinion

The Commissioner of Internal Revenue having determined a deficiency in income and profits taxes for the year 1919, and his action having been confirmed by order of the Board of Tax Appeals, the taxpayer has appealed to this court. Reversed.

The taxpayer is a New York corporation. In May, 1919, it discharged its general sales manager, who had been employed under a long-term contract which provided as compensation for a commission on the corporation's sales and was not to expire until 1937. In July, 1919, the employee brought suit, and in January, 1922, obtained a judgment, on verdict of a jury, for $21,019.19. An appeal by the corporation utimately resulted in affirmance by the court of last resort (Farquhar v. American Code Co., 234 N. Y. 650, 138 N. E. 483) in January, 1923. The judgment was then paid.

The corporation kept its books and made its income-tax returns on the accrual basis. Although contesting the employee's suit and denying that his discharge was wrongful, it set up on its books for the year 1919, as a reserve for liability for breach of the contract, the sum of $14,764.79, such amount being computed upon the basis of the commissions which the employee would have earned during the year had he not been discharged. At the close of the year 1920 this reserve was increased in an amount similarly computed. Before the books were closed for the year 1921, the judgment was rendered, and the reserve account was then adjusted to conform to the amount of the judgment. In the taxpayer's return for 1919 no deduction of the aforesaid reserve for that year was made, because the commissioner had ruled that it would not be permitted; but in January, 1925, its 1919 return being then in process of audit by the Income Tax Bureau, the taxpayer filed a claim for refund, asserting the right to deduct from its gross income for 1919 the amount of its liability for breach of the contract as established by the judgment, and claiming that such deduction entitled it to a refund of $9,364.85. The commissioner disallowed the claim and determined a deficiency in tax of $122.91. His action was confirmed by the Board of Tax Appeals, whose opinion is reported in 10 B. T. A. 476.

Clark H. Hebner, of New York City, for appellant.

Mabel Walker Willebrandt, Asst. Atty. Gen. (Sewall Key and John Vaughan Groner, Sp. Asst. Attys. Gen., and C. M. Charest, Gen. Counsel, Bureau of Internal Revenue, of Washington, D. C. of counsel), for respondent.

SWAN, Circuit Judge (after stating the facts as above): The correctness of the action of the commissioner depends upon the construction of the revenue act of 1918. Section 234 (a) of that act
33 (40 Stat. 1077) permits a corporation to deduct from its gross income:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *

"(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise. * * *"

The act also permits taxpayers to file returns on the accrual basis if their books are so kept. Section 232 (40 Stat. 1077) directs that the net income of corporations shall be computed on the same basis

as is provided in subdivision (b) of section 212. That subdivision (40 Stat. 1064) provides:

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the commissioner does clearly reflect the income. * * *"

Under the authority of section 1309 (40 Stat. 1143), the commissioner, with the approval of the Secretary of the Treasury, promulgated regulations for the enforcement of the provisions of the act. Article 111 of Regulations (1920 ed.) reads in part as follows:

"ART. 111. WHEN CHARGES DEDUCTIBLE.— * * * The expenses, liabilities or deficit of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrual basis has the right to deduct all authorized allowances whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes, or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. A loss from theft or embezzlement occurring in one year and discovered in another is deductible only for the year of its occurrence. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement, or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. See section 252 of the statute and articles 1031–1038."

The problem presented is whether the foregoing provisions of the statute and the regulations permit a taxpayer, who has committed a breach of contract in 1919, and sets up on its books a reserve for such liability, and files a return on the accrual basis, to deduct from its gross income for such year the amount of its liability as established by judgment rendered in a subsequent year.

If the judgment had been rendered early in 1920 and prior to the time when the taxpayer was required to file its 1919 return, it would seem clear that the liability should be considered as a business expense incurred, or a loss sustained, during the year when the contract was broken. Although the amount of the damages was deter-

mined later, all the facts which gave rise to the liability occurred in 1919. It is settled contract law that damages are suffered when the contract is broken, and are assessed as of that time, their amount being the value of the contract to the plaintiff at the time of the breach. (Parker v. Russell, 133 Mass. 74, 75; Pierce v. Tenn. Coal Co., 173 U. S. 1, 16, 19 S. Ct. 335, 43 L. Ed. 591.) Under the regulation above quoted, a taxpayer making returns on the accrual basis is required to deduct all authorized allowances "whether paid in cash or set up as a liability," and provision is made in the final sentence of article 111 for corrections by amended returns when the amount of the loss is ascertained subsequent to the year of its occurrence.

In Appeal of Producers' Fuel Co. (1 B. T. A. 202), it was held that a taxpayer's liability for damages on account of a breach of contract in 1920 was a loss sustained and deductible in that year, although the amount of the damages, determined by negotiation, was agreed upon and paid during the following year. The reserves which the taxpayer had set up on its books and deducted in
34 its return for 1920 were slightly too large, and the board substituted for the orginal estimates the amount of loss as ultimately determined by payment. Subsequently, however, the Board of Tax Appeals limited the foregoing decision to cases in which the taxpayer admits its liability, as by offer of settlement, immediately after the breach of contract. (Hidalgo Steel Co. v. Commissioner, 8 B. T. A. 76.)

This ruling was followed in the case at bar. The basis for the distinction is not apparent to us. The legal liability is the same, whether the suit is defended or not. It is not the admission, but the breach of contract, which creates the liability. The admission of liability by offering a settlement which merely becomes the basis of negotiation between the parties concededly does not determine the amount of the deduction. This was held in Appeal of Producers' Fuel Co., supra. The taxpayer must, it is true, admit to itself the probability of liability by setting up a reserve upon its boks to provide for it, but we find nothing in the revenue act of 1918 which makes an admission to the creditor a material fact in determining whether the reserve is an authorized deduction.

While the amount of the appellant's liability was not ascertained until a future year, we think that the loss was sustained when the contract was broken and must be considered before the income of that year can be determined. When books are kept on an accrual basis, estimated reserves for unliquidated liabilities must necessarily be used. This was recognized in United States v. Anderson (269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347). There it was held that a taxpayer, who filed on an accrual basis, must deduct from 1916 gross income the tax imposed on munition manufacturers for that year, although the tax was not assessed and paid until 1917. In referring to Treasury Decision 2433, which is analogous to article 111 of Regulations 45, Mr. Justice Stone, at page 438 of 269 U. S. (46 S. Ct. 133), says:

"It also provided in substance that when the taxpayer, following a consistent accounting practice, sets up reserves to meet liabilities, the 'amount of which or date of maturity' is not definitely determinable, such reserve may be deducted from gross income. The decision also laid down a procedure for readjusting such reserves when the amount actually required for that purpose was definitely ascertained, and provided that if returns upon this basis of 'accrual or reserves' did not reflect true net income, the taxpayer would not be permitted to make its return on any other basis than that of 'actual receipts and disbursements.'"

We think the principle of the Anderson decision covers liability for breach of contract no less than liability for unassessed taxes. In either case all the facts which create the liability have occurred before the end of the year; in the one, the liability is to be liquidated by a jury; in the other, by the Commissioner of Internal Revenue. In the case of taxes the possibility of setting up a reserve accurately measuring the liability may be greater than in the case of breach of contract. But the difficulty of forecasting the damages which the jury may award is not present in the instant case, for judgment had already been rendered when the commissioner was asked to allow the deduction.

We find nothing in Lewellyn v. Electric Reduction Co. (275 U. S. 243, 48 S. Ct. 63, 72 L. Ed. 262), which is inconsistent with considering appellant's contract liability as a loss sustained in 1919. The question there was whether an asset (a contract right to receive goods paid for in advance), which was believed to be good and was carried on the books as a receivable, should be treated as a loss in the year when the asset was ascertained to be worthless, or in the year when it was created by prepayment for the goods. Whether the taxpayer kept his books on a cash or an accrual basis does not appear, but he did not charge off the asset in the year in question. In the instant case we are not dealing with an asset believed to be good, but subsequently found worthless, but with a liability for which a reserve was set up on the books in the year when the contract was broken.

For the reasons given, we hold that the loss was sutained during the year 1919, and should be allowed as a deduction from gross income for that year. It does not appear to be disputed that if the deduction is made the taxpayer will be entitled to a refund in the sum of $9,364.85. The order of redetermination of deficiency is reversed and the cause remanded to the Board of Tax Appeals for entry of an order in conformity with this opinion.

35 In United States Circuit Court of Appeals, Second Circuit

AMERICAN CODE COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

APPEAL from the United States Board of Tax Appeals.

Decree

Filed Jan. 21, 1929

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals and was argued by counsel.

On consideration whereof it is now hereby ordered, adjudged, and decreed that the order of said board be, and it hereby is, reversed and cause remanded with instructions to enter an order in conformity with the opinion of this court.

It is further ordered that a mandate issue to the said board in accordance with this decree.

M. T. M.
T. W. S.

36 [File endorsement omitted.]

37 [Clerk's certificate to foregoing transcript omitted in printing.]

○

Supreme Court of the United States

Order allowing certiorari

Filed May 20, 1929

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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No. ~~848~~ 67

In the Supreme Court of the United States

OCTOBER TERM, 1928

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

AMERICAN CODE COMPANY, INCORPORATED

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

U.S. GOVERNMENT PRINTING OFFICE: 1929

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In the Supreme Court of the United States

OCTOBER TERM, 1928

No. ——

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

AMERICAN CODE COMPANY, INCORPORATED

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

PETITION

The Attorney General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the decree of the United States Circuit Court of Appeals for the Second Circuit entered in the above case on January 21, 1929 (R. 19), reversing the decision of the United States Board of Tax Appeals (R. 10).

STATEMENT

The question presented is whether a loss, suffered by respondent through an adverse judgment should be deducted in the year in which the cause of action

arose or in that in which the cause was finally determined.

The findings of fact made by the Board of Tax Appeals are as follows (R. 8–9):

The taxpayer is a New York corporation, organized in the year 1914 in the Borough of Manhattan of the city of New York.

On January 3, 1919, the taxpayer entered into a contract of employment with one Cosmo Farquhar for a term to begin on January 3, 1919, and to end on February 1, 1937, the compensation of the employee to be a commission based upon the sales made in the taxpayer's business.

On May 1, 1919, the taxpayer discharged the said Cosmo Farquhar from its employ.

In July, 1919, Farquhar began action against the taxpayer in the Supreme Court of New York County to recover commissions due him for April, 1919, alleged to be $100, and for breach of the contract of employment, claiming damages for such breach in the amount of $100,000. The taxpayer defended such action on the ground that Farquhar had previously breached his contract of employment and that his discharge was justified by reason of his failure to perform his duties. This action was reached for trial in January, 1922, and resulted in a verdict by the jury against the taxpayer and an award of damages in favor of Farquhar for breach of contract in the sum of $21,019.19.

The taxpayer appealed to the appellate division of the Supreme Court, State of New York, which court, on June 2, 1922, affirmed the judgment. Taxpayer then appealed to the Court of Appeals of the State of New York, in which court the judgment was again affirmed on the 16th day of January, 1923.

The taxpayer paid the amount of said judgment in January, 1923.

The taxpayer kept its books and made its income-tax returns on the accrual basis.

The taxpayer, at the close of the year 1919, set up on its books as a reserve for the breach of the contract of employment the amount of $14,764.79, such amount having been computed at the rates of commission and on the basis specified in the said contract. At the close of the year 1920 this reserve was increased on the taxpayer's books by $32,994.09 to conform to the amount of its liability computed on the same basis, and at the close of the year 1921, judgment having been rendered early in January, 1922, before the books had been closed for 1921, the reserves so set up on its books, amounting to $47,458.88, were adjusted to the liability as fixed by the judgment against the taxpayer in the sum of $21,019.19.

On October 28, 1919, the taxpayer wrote the Commissioner that its employee was suing to recover commissions due under the contract and made a

written request of the Commissioner of Internal Revenue for permission to deduct from taxpayer's income-tax return for 1919 the accumulated commissions which would be due on December 31, 1919, under the contract, which request was denied on November 11, 1919.

The taxpayer, in compliance with said ruling by the Commissioner, did not deduct in its 1919 income-tax return the amount set up as a reserve for 1919 commissions, but on January 21, 1925, its 1919 return being then in process of audit by the Income Tax Bureau, the taxpayer filed a claim for refund with the Commissioner of Internal Revenue, in which it claimed the right to deduct from its income for the year 1919 the amount of its liability for breach of the said contract of employment, the sum of $21,019.19, and that by reason of such deduction it was entitled to a refund of income tax paid for 1919 in the sum of $9,364.85.

The Commissioner, in a notice dated September 17, 1925, rejected such claim for refund and asserted a deficiency in tax against the taxpayer for 1919 of $122.91.

The decision of the United States Board of Tax Appeals affirmed the determination of the Commissioner. Upon respondent's appeal to the Circuit Court of Appeals for the Second Circuit, that court reversed the decision of the Board of Tax Appeals and allowed the respondent to take the deduction in the year 1919.

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred:

I. In reversing the order of redetermination of the Board of Tax Appeals.

II. In holding that the item in question was properly deductible from gross income for the year 1919 within the provisions of Section 234 (a) of the Revenue Act of 1918.

REASONS FOR GRANTING THE WRIT

I. The decision of the Circuit Court of Appeals is in conflict with the decision of the United States Court of Claims in the case of *Malleable Iron Range Co.* v. *United States,* 62 C. Cls. 425, and with the decision of that court in the same case rendered after remand by this Court, 65 C. Cls. 441.

II. The decision of the Circuit Court of Appeals is also in conflict with the principles set forth by this Court in *United States* v. *Anderson,* 269 U. S. 422, and *Lewellyn* v. *Elec. Reduction Co.,* 275 U. S. 243.

III. The decision of the Circuit Court of Appeals unsettles the established practice of the Bureau of Internal Revenue as to the time when certain deductions can be taken. The issue here is identical with that of the case of *Malleable Iron Range Co.* v. *United States, supra,* in which certiorari was allowed, but in which this Court remanded to the Court of Claims for further findings of fact without hearing or decision on the merits.

It is desirable, therefore, that a writ of certiorari issue in this case that the decision of this Court may establish a settled rule for the guidance of the courts and the Treasury Department.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Second Circuit should be granted.

WILLIAM D. MITCHELL,
Attorney General.

April, 1929.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals is reported in 10 B. T. A. 476. (R. 9.) The opinion of the Circuit Court of Appeals has not been reported, but will be found at page 14 of the record.

JURISDICTION

The judgment of the Circuit Court of Appeals sought to be reviewed was entered January 21, 1929. (R. 19.) Jurisdiction to issue the writ is found in the provisions of Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925. The appeal to the Board of Tax Appeals was filed prior to the enactment of the Revenue Act of 1926, and decision by the Board was subsequent to the passage of that Act. (R. 1.) This case, therefore, involves the question of the validity of the provisions of law for appeals from the Board of Tax Appeals to the courts raised in the cases of *Old Colony Trust Company* v. *Commissioner of Internal Revenue,* No. 130, and *Commissioner of Internal Revenue* v. *Old Colony Railroad,* No. 407. As that question has not been determined and is considered in the briefs submitted by the Govern-

ment in those two cases, no further discussion here is deemed necessary.

QUESTIONS PRESENTED

May respondent take a deduction in 1919, under Section 234 (a) of the Revenue Act of 1918, for a loss resulting from its breach of a contract in that year but only determined by final decision of an appellate court in 1923?

STATUTES INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057:

> SEC. 234 (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> * * * * *

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

STATEMENT

The facts are sufficiently stated in the petition for certiorari.

ARGUMENT

The respondent herein discharged an employee, with whom it had a long-term contract of employment, in the year 1919. In that same year this employee brought action against the respondent alleging a breach of contract. The respondent denied liability, asserting that the employee had breached the contract.

In the year 1919 respondent, who kept its books on the accrual basis, set up a reserve to take care of a possible judgment against it. This reserve was measured by the amount the employee would have earned had he continued in respondent's employ. During the year 1920 this reserve was increased in the same manner. In January, 1922, judgment was rendered against respondent and the reserve, as of the end of the year 1921, was adjusted in accordance therewith. In January, 1923, this judgment was affirmed by the Court of Appeals of the State of New York, and paid.

In 1925 the respondent claimed a refund for the year 1919. This claim was predicated upon its asserted right to deduct in that year the amount of the judgment which was rendered against it in 1922 and paid in 1923. The Circuit Court of Appeals for the Second Circuit allowed the deduction in the earlier year, basing its opinion largely upon the

theory that damages are suffered when the contract is broken, and are assessed as of that date.

This decision is in direct conflict with the decision of the Court of Claims in *Malleable Iron Range Co.* v. *United States,* 62 C. Cls. 425. In that case the petitioner asked that it be allowed to deduct in 1918 a reserve set up to take care of a judgment rendered against it in that year, but from which it had appealed. In 1919 petitioner increased the reserve to meet a possible increase in the judgment. In 1920 the Circuit Court of Appeals increased the judgment and, as increased, affirmed it. The Court of Claims held that "when the amount in question is in litigation it can not be determined until the litigation is ended" (p. 432), and refused to allow the deduction in the earlier years. This Court allowed certiorari (273 U. S. 688) but remanded the case for further findings of fact, without passing on the merits (273 U. S. 674). Upon remand (65 C. Cls. 441) it was developed that in 1918 the petitioner had deposited certain funds with a trust company to abide the decision of the Circuit Court of Appeals, and, as to this amount over which petitioner had lost control, deduction was allowed. During the year 1919 petitioner had not parted with any further sums of money and the Court of Claims reaffirmed its earlier decision as to that year. See also *Consolidated Tea Co.* v. *Bowers* (S. D. N. Y.), 19 F. (2d) 382; and *contra, Becker Bros.* v. *United States* (C. C. A. 2nd), 7 F. (2d) 3.

This latter case may be reconciled with the second *Malleable Iron Range Co. case, supra,* as the taxpayer, who was the judgment debtor, had actually parted with the amount of the judgment in the earlier years.

It is also believed that while the facts in this case distinguish it from the cases of *United States* v. *Anderson,* 269 U. S. 422, and *Lewellyn* v. *Elec. Reduction Co.,* 275 U. S. 243, the decision here conflicts with the principles there laid down.

The first of these cases involved the right of a taxpayer, who kept books on an accrual basis, to deduct from income of the year 1917 taxes due for the year 1916, but not payable until the latter year. The Revenue Act of 1916 became effective on September 8, 1916. It appears that the respondent, Anderson, set up on his books a monthly reserve to take care of these taxes, beginning with the month in which the Act was passed. This Court, in holding that the deduction must be taken in the earlier year, said (p. 441):

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.

It is apparent that there had been no determination of either of these conditions precedent to an accrual in the instant case. Nothing had here

occurred to "fix the amount" or to "determine the liability." It is entirely true, as stated by the Circuit Court of Appeals for the Second Circuit, that damages are suffered and assessed as of the time of the breach, but at that time there is only a controverted and speculative liability. This liability requires the subsequent action of jury and court to convert it into such a definite or ascertainable loss as the taxing statutes contemplate.

In the *Elec. Reduction Co. case, supra,* the respondent contracted for the purchase of certain ore in the year 1918 and accepted and paid a draft therefor. It never received the ore and instituted actions to recover the money paid. In 1922 litigation was terminated without collection and respondent asked a deduction for the loss in the year 1918. This Court concluded that the loss was sustained in the year in which the litigation was terminated. In that case court action and its termination merely proved worthlessness, whereas here the loss, itself, was contingent on court action. There the question did not arise as to the relationship of the time of assessing damages with the time of accruing tax-free reserves.

The position of the Commissioner in the instant case is directly supported by Article 111 of Regulations 45, which, in effect, is overturned by this decision. This article is analogous to Treasury Decision 2433, which was approved by this Court in *United States* v. *Anderson, supra.* In principle it

has been consistently followed by the Bureau of Internal Revenue. (See Article 111 of Regulations 62, and Article 112 of Regulations 65 and 69.)

In view of the effect of this decision upon a settled departmental interpretation and of the confusion resulting from a direct conflict between this decision and the decision of the Court of Claims in the *Malleable Iron Range Company cases*, it is desirable that a writ of certiorari issue in order that a determination be made for the guidance of the courts and of the Treasury Department.

Respectfully submitted.

WILLIAM D. MITCHELL,
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MABEL WALKER WILLEBRANDT,
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ALFRED A. WHEAT,

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General Counsel,
Bureau of Internal Revenue,

P. S. CREWE,
Special Attorney,
Bureau of Internal Revenue,
Of Counsel.

APRIL, 1929.

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No. 67

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

AMERICAN CODE COMPANY, INCORPORATED

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1929

No. 67

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

AMERICAN CODE COMPANY, INCORPORATED

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 7–9) is reported in 10 B. T. A. 476. That of the United States Circuit Court of Appeals for the Second Circuit (R. 14–18) is reported in 30 F. (2d) 222.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 21, 1929. (R. 19.) Petition for writ of certiorari was filed on April 19, 1929, and granted on May 20, 1929. (R. 21.) The

jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1919 respondent broke a contract with its employee who instituted suit for damages in the same year. Respondent asserted a previous breach of the contract by the employee and defended the suit. The case was decided against the taxpayer in the lower court in 1922 and this decision was finally affirmed in 1923. Respondent kept its books and made its income tax returns on the accrual basis and set up a reserve at the end of 1919 on account of its alleged liability for the breach of the contract. Upon these facts the question is whether the amount of the judgment rendered against it in a later year is a loss sustained by the respondent during 1919 within the meaning of Section 234 (a) of the Revenue Act of 1918.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1064, 1077, 1078:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *;
>
> * * * * *

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

* * * * *

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

Regulations 45 (1920 ed.) provide:

ART. 111. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See articles 21–24

and 52. The expenses, liabilities or deficit of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. A loss from theft or embezzlement occurring in one year and discovered in another is deductible only for the year of its occurrence. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. See section 252 of the statute and articles 1031–1038.

STATEMENT OF FACTS

The findings of fact made by the Board of Tax Appeals are as follows (R. 8–9):

The taxpayer is a New York corporation, organized in the year 1914 in the Borough of Manhattan of the city of New York.

On January 3, 1919, the taxpayer entered into a contract of employment with one Cosmo Farquhar for a term to begin on January 3, 1919, and to end on February 1, 1937, the compensation of the employee to be a commission based upon the sales made in the petitioner's business.

On May 1, 1919, the taxpayer discharged the said Cosmo Farquhar from its employ.

In July, 1919, Farquhar began action against the taxpayer in the Supreme Court of New York County to recover commissions due him for April, 1919, alleged to be $100, and for breach of the contract of employment, claiming damages for such breach in the amount of $100,000. The taxpayer defended such action on the ground that Farquhar had previously broken his contract of employment and that his discharge was justified by reason of his failure to perform his duties. This action was reached for trial in January, 1922, and resulted in a verdict by the jury against the taxpayer and an award of damages in favor of Farquhar for breach of contract in the sum of $21,019.19.

The taxpayer appealed to the Appellate Division of the Supreme Court, State of New York, which

court, on June 2, 1922, affirmed the judgment. Taxpayer then appealed to the Court of Appeals of the State of New York, in which court the judgment was again affirmed on the 16th day of January, 1923.

The taxpayer paid the amount of said judgment in January, 1923.

The taxpayer kept its books and made its income tax returns on the accrual basis.

The taxpayer, at the close of the year 1919, set up on its books as a reserve for the breach of the contract of employment the amount of $14,764.79, such amount having been computed at the rates of commission and on the basis specified in the said contract. At the close of the year 1920 this reserve was increased on the taxpayer's books by $32,994.09 to conform to the amount of its liability computed on the same basis, and at the close of the year 1921, judgment having been rendered early in January, 1922, before the books had been closed for 1921, the reserves so set up on its books, amounting to $47,458.88, were adjusted to the liability as fixed by the judgment against the taxpayer in the sum of $21,019.19.

On October 28, 1919, the taxpayer wrote the Commissioner that its employee was suing to recover commissions due under the contract and made a written request of the Commissioner of Internal Revenue for permission to deduct from taxpayer's income-tax return for 1919 the accumulated

commissions which would be due on December 31, 1919, under the contract, which request was denied on November 11, 1919.

The taxpayer, in compliance with said ruling by the Commissioner, did not deduct in its 1919 income-tax return the amount set up as a reserve for 1919 commissions, but on January 21, 1925, its 1919 return being then in process of audit by the Income Tax Bureau, the taxpayer filed a claim for refund with the Commissioner of Internal Revenue, in which it claimed the right to deduct from its income for the year 1919 the amount of its liability for breach of the said contract of employment, the sum of $21,019.19, and asserted that by reason of such deduction it was entitled to a refund of income tax paid for 1919 in the sum of $9,364.85.

The Commissioner, in a notice dated September 17, 1925, rejected such claim for refund and asserted a deficiency in tax against the taxpayer for 1919 for $122.91.

The taxpayer thereupon appealed to the United States Board of Tax Appeals, and the Board, upon hearing, affirmed the determination of the Commissioner. (R. 10.) Taxpayer then brought the case by petition for review to the Circuit Court of Appeals for the Second Circuit, and that court, after hearing, reversed the decision of the Board. (R. 19.)

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SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

I. In reversing the order of redetermination of the Board of Tax Appeals.

II. In holding that the item in question was properly deductible from gross income for the year 1919, within the provisions of Section 234 (a) of the Revenue Act of 1918.

SUMMARY OF ARGUMENT

Where a private cause of action against a taxpayer arose in one tax year but liability thereon was denied, and not finally determined until several years later, following an adverse judgment, there is no accrual of the loss occasioned by that judgment in the year in which the cause of action arose, even though taxpayer set up on its books a reserve to meet the judgment, if suffered. A loss in such a case grows out of the original facts which gave rise to the action, but only becomes a loss upon the determination of liability and the assessment of damages by court and jury. It is thus plain that at the time the cause of action arose all the events had not occurred which either determined the liability or even approximately fixed the amount of that liability. Until these elements are ascertained, it must follow, under the rule laid down by this Court in *United States* v. *Anderson*, 269 U. S. 422, that there can be no accrual. To hold otherwise would be to ignore the effect of the rule laid down in the *Anderson case* and generally fol-

lowed by the courts and the Board of Tax Appeals and to unsettle a practice consistently followed by the Department charged with the enforcement of the tax laws.

ARGUMENT

A LOSS OR EXPENSE INCURRED BY A JUDGMENT FOR THE BREACH OF A CONTRACT IS ONLY DEDUCTIBLE IN THE YEAR IN WHICH THE LIABILITY AND THE DAMAGES BECOME DEFINITELY FIXED BY FINAL ADJUDICATION, EVEN THOUGH A RESERVE WAS SET UP IN THE YEAR IN WHICH THE BREACH OCCURRED

The decision of this Court in *United States* v. *Anderson,* 269 U. S. 422, established the principle that a taxpayer keeping his books on the accrual basis could deduct an expense only in the year in which all the events occurred which determined the liability upon which the expense was based.

In the instant case the Circuit Court of Appeals has allowed the deduction to be taken in 1919, although neither the liability nor its amount was determined in that year. The respondent defended the suit which was commenced in that year, alleging a previous breach by the employee, and its liability was not finally adjudicated until 1923. The decision of the Circuit Court of Appeals is largely predicated upon the fact that the respondent set up a reserve in the year in which the contract was broken and upon the principle of contract law that damages are suffered at the time a contract is broken.

In the *Anderson case, supra,* this Court held that taxes for the year 1916 became fixed and determinable in that year, though not due until 1917, and sustained the decision of the Commissioner that a deduction for such taxes should be taken in 1916 rather than in 1917. It was there said (p. 441):

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued.

Applying the above statement to the facts of the instant case, it is apparent that, while the loss suffered by respondent arose out of its action in discharging its employee in 1919, the determination that there would be a loss and the fixation of the amount of that loss were dependent upon the action of the courts, which did not occur until a subsequent year. It is manifest, therefore, that in 1919 all the events had not occurred which fixed even the approximate amount of the judgment and determined the liability of the taxpayer to pay it. In

such circumstances we submit that there could be no accrual in 1919.

In *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243, the taxpayer contracted with third parties for the purchase of certain ores and, in compliance with the terms of that contract, accepted and paid a draft, believing that certain of the ores had been shipped to it. In fact, they had not been, and in large part never were. It thereafter instituted action against the other parties to the contract to recover the amount of the draft paid by it. Those proceedings were not terminated for several years, and it was only in the latter of these years that it was finally determined that the sum in question was irrevocably lost. Taxpayer thereupon filed an amended return for the year in which the contract had been made, asserting that it should be allowed to deduct the loss suffered in that earlier year. The Commissioner determined that the loss was only deductible in the later year, and this Court sustained the Commissioner, saying (p. 246):

> But we do not think that a loss resulting from a buyer's prepayment to a seller who proves to be irresponsible is necessarily sustained, in the statutory meaning, as soon as the money is paid. The statute was intended to apply not only to losses resulting from the physical destruction of articles of value but to those occurring in the operations of trade and business, where the business man has ventured on a course of action

> in the reasonable expectation that the promised conduct of another will come to pass. Not only the future success of the business but its present solvency depends on the probable accuracy of his prophecy. Only when events prove the prophecy to have been false can it be said that he has suffered. His case is not like that of a man who fails to learn of the theft of his bonds or the burning of his house until a year after the occurrence; but rather resembles the position of a merchant who buys in one year, for sale in the next, merchandise which shifting fashion renders unsaleable in the latter. It may well be that he whose house has been burned has sustained a loss whether he knows it or not and may recover a tax paid in ignorance of that material fact. But we can not say that the merchant whose action has been based not merely on ignorance of a fact but on faith in a prophecy—even though the prophecy is made without full knowledge of the facts—can claim to have sustained a loss before the future fails to justify his hopes.

It is contended that the facts of that case are fairly analogous to those here involved, and that the conclusion reached therein should have been followed in this case. The controlling factor in each case was the determination that there was an actual loss, and a fixation of its amount. In the *Electric Reduction Co. case* the loss was occasioned by the breach of a contract by another. In the year in which the breach occurred, it was impossible to

ascertain whether or not a loss would result. In the instant case the loss was occasioned by the breach of a contract by the taxpayer. As respondent denied liability, it was equally impossible in the year of the breach to determine that there would be a loss.

In the *Electric Reduction Co. case* it was further said (p. 247):

> Here the only fact relied upon to show a loss is the outcome of the litigations two years after respondent's payment to Jouravleff. There is nothing in the findings from which we could conclude that the respondent in 1918 had ceased to regard his rights under the contract as having value or that there was then reasonable ground to suppose that efforts to enforce them would be fruitless. On the findings respondent is not entitled to recover.

Since the fact relied upon in the instant case to show a loss is the outcome of litigation in a subsequent year, the analogy between the two cases is apparent. The deduction sought in the instant case, like that in the *Electric Reduction Co. case,* is unlike that which would be sought in the case of a burned house or a stolen bond. There the loss, even though unknown to the victim, is determined by the fire or the theft without the intervention of any other factor. Here the loss is not alone determined from the facts of the original transaction but requires, in addition thereto, the subsequent

action of court and jury, which may determine that there is no loss, that the loss is exceedingly small, or that it is as large as the total amount sued for.

The Circuit Court of Appeals distinguished the *Electric Reduction Co. case* on the ground that: "Whether the taxpayer kept his books on a cash or an accrual basis does not appear, but he did not charge off the asset in the year in question." (R. 18.) It is submitted that neither the fact that the taxpayer was not shown to be on an accrual basis, nor that he had not yet abandoned hope of recovery, was the controlling consideration in the *Electric Reduction Co. case.* Rather it is believed that the determinative factor was that in the taxable year 1919 the events which proved the claim to be uncollectible had not yet happened.

With respect to deductible losses, the only difference between a taxpayer on the accrual basis and a taxpayer on the cash basis is that the former is permitted to take a loss when the liability becomes fixed while the latter must await the actual payment. The same certainty is required in both cases and in neither can a deduction be taken for a loss which is indefinite or contingent.

The same principle was applied by the Court of Claims in the case of *Malleable Iron Range Co.* v. *United States,* 62 Ct. Cls. 425, which involved the deductibility of a loss resulting from a judgment, the taxpayer being on the accrual basis. In that case a judgment was rendered against the taxpayer

in the year 1918. The taxpayer appealed from the judgment, which was affirmed in 1920 for an increased amount. The taxpayer set up on its books in the year 1918, as an accrued liability, the amount of the judgment, together with interest to the end of the year. In order to provide against an increase in the judgment the taxpayer accrued an additional sum on its books for 1919. In making its returns for 1918 and 1919, the taxpayer attempted to deduct the amounts which had been set up on its books. Those deductions were not allowed by the Commissioner of Internal Revenue, since the liability of the taxpayer to pay the judgment was not determined until 1920. Applying the law and the regulations to these facts, the Court of Claims held that the deductions were properly disallowed, and said (pp. 432, 433):

> It would seem plain from the foregoing that when there is a question of whether or not there is any liability, no amount can accrue until it is determined that a liability exists. When the amount in question is in litigation it cannot be determined until the litigation is ended. * * *
> Until all the events occurred which fixed the amount to be deducted, and determined the liability of the taxpayer to pay it, there was no method by which the Commissioner of Internal Revenue could assess the amount of the tax.

Petition for certiorari in that case was not opposed by the United States and was granted by this Court (273 U. S. 688). Thereafter upon motion the case was remanded to the Court of Claims for additional findings in respect to the outlay in bonds or money required to be deposited by the taxpayer in securing a stay of the execution of the judgment (273 U. S. 674).

It appeared from the findings, as amended in compliance with the order of this Court, that at the time of the judgment against it in the District Court, the taxpayer had deposited with a trust company bonds in an amount greater than the judgment. (65 Ct. Cls. 441.) With these additional findings the Court of Claims said that the question was whether, in the circumstances of this case, this *outlay* was a proper accrual under the statute. The Court of Claims held that, by its action in putting the bonds in trust, the taxpayer destroyed their availability as an asset in the business as completely as if their value in cash had been withdrawn from its treasury and that its financial position was as much affected by the deposit of the bonds as it would have been by the deposit of the equivalent cash. It was accordingly held that the taxpayer was entitled to the deduction claimed for 1918. However, the deduction claimed for 1919 was not allowed, for the reason that the taxpayer had not parted with any further sums of money in that year and no facts had occurred to justify an

accrual, which was merely a precautionary measure based upon no known fact, but upon a possibility, a speculation.

The second decision of the Court of Claims clearly distinguishes between an accrual based upon mere possibility, which we submit is the situation in the case at bar, and an actual outlay of funds. It is evident that the deduction for 1918 was allowed in that case, not because it had been accrued on the books, but because there had been an actual outlay. With respect to both of these deductions the decision gives effect to the fundamental rule underlying the decisions in *United States* v. *Anderson, supra,* and *American National Co.* v. *United States,* 274 U. S. 99, that the computation must be made in such a manner as clearly reflects the taxpayer's income.

A conclusion similar to that of the Court of Claims in the second *Malleable Iron Range decision* was reached by the Circuit Court of Appeals for the Second Circuit in *Becker Bros.* v. *United States,* 7 F. (2d) 3. In that case the judgment was rendered against plaintiff in 1914 and plaintiff deposited in escrow a sum of money sufficient to meet this judgment. In 1916, following appeal and affirmance, the judgment was paid. The court, resting its decision largely upon the taxpayer's loss of the use of its money deposited in escrow, allowed the deduction in the earlier year. The decisions in those two cases are therefore clearly distinguishable from the instant one.

In *Consolidated Tea Co.* v. *Bowers* (S. D. N. Y.), 19 F. (2d) 382, the question was whether a judgment rendered against the Tea Company in 1919, appealed and paid on affirmance in 1921, was deductible in 1919. The Tea Company kept its books and filed its return on the accrual basis and set up on its books a reserve for the judgment in 1919. The question whether the deduction might be taken for the year in which the claim arose was not involved in that case, but it was held that the deduction should not be allowed for 1919 the court saying (p. 384):

> From a tax income standpoint, both logical and practical, reasons seem to me to support the conclusion that a loss should be deductible, not in the year when the judgment was rendered, but in the year when the claim was adjudicated to be final and definite, or possibly, under certain circumstances, in the year when the claim originated.
>
> In its appeal from the judgment, the tea company was denying that the claim against it was valid and that the judgment was anything more than a step toward the final determination of the claim, and that the company itself did not regard the claim as a fixed definite obligation until the judgment was affirmed by the appellate court.

A further application of the principle that an expense can not be accrued until the liability has become fixed and determined was made in *S. Naitove & Co.* v. *Commissioner* (D. C. App.), 32 F.

(2d) 949; certiorari denied October 21, 1929. In that case an agreement had been made between a company and certain of its employees under which the employees were to share in the profits of the company earned in the taxable year, on condition that the sums to which the employees became entitled should remain at the risk of the business for five years and that the discharge or withdrawal of an employee from the company during that period should terminate his right to any sum credited to him. The taxpayer company was on the accrual basis and sought to take deductions in the first year for the amounts which had been set up on the books as due to the employees. The deduction was denied on the ground that the events which were to determine and fix the company's liability to its employees could not occur until the expiration of the five years.

See also *Kaufmann Department Stores, Inc.*, 11 B. T. A. 949, (C. C. A. 3d) 34 F (2d) 257.

The essence of the principle applicable to all of these cases is that, while a taxpayer on the accrual basis may accrue a liability before it is actually paid, the taxpayer is not authorized to accrue a liability which is contingent upon the happening of events subsequent to the taxable year involved. Unless all the events have occurred which determine the liability of the taxpayer, there can be no accrual.

The theory of accrual as applied to a liability is identical with the theory as applied to income. The fact that a taxpayer keeps its books on an accrual basis does not compel it to pay taxes on contingent income or bookkeeping entries. The Treasury Department has ruled that where an item is in dispute and there is no assurance that it will be paid, it should not be reported as income until there is an adjudication that it is due, or a settlement of the dispute. Sol. Op. 41, C. B. 3–364; O. D. 642, C. B. 3–231; I. T. 1471, C. B. I–2, 67. Accordingly, if the employee in the instant case had kept his accounts on the accrual basis, he would not have been chargeable with the receipt of the amount of the judgment until it became fixed and determined by the decision of the court of last resort.

The liability of the taxpayer in the instant case is no more definite than the contingent income to the employee, and the practice of the Department deals with it in a consistent manner. A. R. R. 915, C. B. I–2, 44; O. D. 879, O. D. 917, C. B. 4, 142; Regulations 45, Article 111. This article is derived from and analogous to Treasury Decision 2433, which was approved by this Court in *United States* v. *Anderson, supra.* In principle it has been consistently followed by the Treasury. See Regulations 62, Article 111; Regulations 65, Article 112; Regulations 69, Article 112.

In the instant case the Circuit Court of Appeals, though seeking to reconcile its decision with the

decision of this Court in *United States* v. *Anderson, supra,* has, we submit, departed from the principles announced in that case.

The Circuit Court of Appeals says (R. 16–17):

> Although the amount of the damages was determined later, all the facts which *gave rise* to the liability occurred in 1919. (Italics ours.)

The thought is repeated (R. 18) where the court says:

> We think the principle of the Anderson decision covers liability for breach of contract no less than liability for unassessed taxes. In either case all the facts which *create* the liability have occurred before the end of the year. (Italics ours.)

This is the foundation upon which the court below rested its conclusion that the liability was correctly accrued in 1919, and we submit that it is erroneous. This Court in the *Anderson case* did not predicate its decision upon the occurrence of the facts which *create* or *gave rise* to the liability. The *Anderson* decision rested on the proposition that all the events had occurred which *fixed the amount* and *determined the liability.* Of course it is true that the breach of the contract in the instant case was the fact which subsequently was determined to have created the liability, but the question

whether there had been a breach of the contract and by whom it was broken were the very points at issue in the litigation which ensued between the parties.

Neither party to that litigation was in a position in 1919 to say what effect it would have upon its financial position. The respondent had the full use during 1919 of the amount of the judgment subsequently awarded against it, and any reflection of the transaction in the respondent's accounts in 1919 was based upon a pure contingency. In reality it was insurance against the happening of an event which it was hoped or expected would never happen.

The fact that respondent at the close of the year 1919 set up on its books a reserve for the breach of the contract is not sufficient to permit the accrual of the liability in that year. In *Malleable Iron Range Co.* v. *United States,* and *Consolidated Tea Co.* v. *Bowers, supra,* the fact that a reserve had been set up was not regarded as controlling. The Circuit Court of Appeals in this case seems to have given great weight to this reserve. The opinion (R. 16) sets out Article 111 of Regulations 45 which includes the following:

> A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability.

Construing this regulation, the Circuit Court of Appeals says (R. 17):

> Under the regulations above quoted, a taxpayer making returns on the accrual basis is required to deduct all authorized allowances "whether paid in cash or set up as a liability."

The Circuit Court of Appeals has, we submit, overlooked the fact that it is only an *authorized* allowance which can be set up as a liability. The act of setting up a liability does not conclusively determine the existence of the liability. It is only when all the events have occurred which determine the liability that an allowance for the liability is authorized. In 1919 both the liability and the amount thereof were entirely contingent and we submit that the reserve was unauthorized and in no way affects the question whether respondent may properly deduct from 1919 income the amount of a judgment subsequently awarded against it.

Article 111 of Regulations 45 further provides as follows:

> Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid.

The earlier statement in the regulations permitting a taxpayer on the accrual basis to deduct all

"authorized allowances," whether paid in cash or set up as a liability, is not, as the Circuit Court of Appeals apparently supposed, an exception to the rule that the amount of a judgment is deductible when the claim is put in judgment or paid. Rather, the provision with respect to the "authorized allowances" of the taxpayer on the accrual basis is limited by the provision that the amount of a judgment is deductible when the claim is put in judgment. When the final judgment is *rendered* it becomes an authorized allowance to the taxpayer on the *accrual* basis in the same way that the *payment* of the final judgment becomes an authorized allowance to the taxpayer on a *cash* basis. In other words, the regulation does not purport to permit a taxpayer on the accrual basis to secure an authorized allowance merely by setting up a liability on its books. The Department has construed the regulations as requiring that the reserve must represent an actual, not a contingent liability.

See *Appeal of Greenville Coal Co.*, 3 B. T. A. 1323, 1327; *Appeal of Richmond Light and Railroad Co.*, 4 B. T. A. 91, 93.

The income tax laws do not depend for their administration upon whether a corporation in the exercise of ordinary business prudence treats an item as an asset or as a liability. This is illustrated by the opinion of this Court in *Weiss* v. *Weiner*, 279 U. S. 333, where it was said (p. 335):

> The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. They do not charge for appreciation of property or allow a loss from a fall in market value unless realized in money by a sale. *United States* v. *S. S. White Dental Co.*, 274 U. S. 398, 401. A stockholder does not pay for accumulated profits of his corporation unless he receives a dividend. That is the general principle upon which these laws go. It is true that they allow for obsolescence of buildings, &c., where the loss is of materials, not of money; but there as elsewhere the loss must be actual and present, not merely contemplated as more or less sure to occur in the future.

In the instant case there was neither an actual loss nor an actual liability in 1919 and to permit respondent to cut down its taxable income by the amount of a judgment rendered in subsequent years is a clear distortion of 1919 income.

Even if it were true that the setting up of this reserve entitled the respondent to a deduction, it is clear that the amount allowed by the court below is too large. The reserve set up for 1919 was $14,764.79 (R. 8), but the Circuit Court of Appeals has allowed the amount of the judgment, $21,019.19 (R. 8), as a deduction for 1919. If the deduction must be allowed because of the reserve it should be

limited to the amount of the reserve and the increase in the reserve in 1920 could have no bearing upon the deduction for 1919.

The Circuit Court of Appeals held that the actual amount of damages, though determined in a subsequent year, related back to the year when the contract was broken because of the principle of contract law "that damages are suffered when the contract is broken, and are assessed as of that time, their amount being the value of the contract to the plaintiff at the time of the breach." (R. 17.)

The rule relied upon by the Circuit Court of Appeals is merely a rule of necessity which is resorted to where there is need of coming to some conclusion in regard to the damages which a party has sustained by reason of the breach of a contract. *Dunbar* v. *Dunbar,* 190 U. S. 340, 346. In that case it was held that the rule was not applicable to cases arising under the Bankruptcy Act because (p. 350):

> We do not think that by the use of the language in section 63*a* it was intended to permit proof of contingent debts or liabilities or demands the valuation or estimation of which it was substantially impossible to prove.

For the same reason we submit that the rule is wholly inapplicable here. This Court has already said in *Seattle* v. *Kelleher,* 195 U. S. 351, 359, that: "The principles of taxation are not those of contract." The Revenue Act permits a deduction for

"losses sustained," and we think it is clear that it excludes losses which are only contingent.

It is submitted that the instant case establishes a rule in conflict with other decisions in allowing an accrual, as an expense, of a sum whose amount and very existence were, at the time the deduction was sought, wholly indefinite and speculative. It also conflicts with the interpretation consistently placed upon the statute by the Treasury Department.

The position of the Commissioner in the instant case is directly supported by Article 111 of Regulations 45, *supra*. The later regulations embody the same principle and these consistent rulings are supported by the decisions cited.

To follow the decision in this case would be to unsettle or overturn all of these regulations and would result in the allowance of deductions and the inclusion of profits which were utterly contingent and which in all likelihood could not be definitely determined for a considerable number of years. To illustrate the effect of the principle of the decision of the Circuit Court of Appeals, respondent's discharged employee, keeping his books on an accrual basis, would have had to report as income for tax purposes the amounts which he would have made had he continued in the employ of respondent during the years 1919, 1920, and 1921. Revision of early returns upon a final determination would be necessary in every case of this sort, with the probability

that in many of them the statute of limitations would have run. The inconveniences which would result from such a method are obvious and are not required by the language of the statute.

CONCLUSION

It is submitted that the decision of the Circuit Court of Appeals is inconsistent with applicable decisions of this Court and in conflict with decisions of other courts; that it is contrary to settled departmental practice in the administration of the tax law; and that it should be reversed.

Respectfully submitted.

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IN THE

Supreme Court of the United States,

OCTOBER TERM, 1928.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

AMERICAN CODE COMPANY, INCORPORATED.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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The Evening Post Job Printing Office, Inc., 154 Fulton St., New York, N. Y.

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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1928

No. 846

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

AMERICAN CODE COMPANY, INCORPORATED.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

Statement.

The facts are fully stated in the opinion of the Court below (Record, p. 15) and in the petition for certiorari.

Question Presented.

Are damages for a breach of contract incurred and sustained on the date of the Breach, entitling a taxpayer, making income tax returns on the accrual basis, to take deduction therefor from income of the year in which the Breach occurred?

Statutes Involved.

This case involves the general law of contracts and Revenue Act of 1918, C. 18, 40 Stat. 1057, Secs. 234, 212 and 232. Sec. 234(a) of said Revenue Act permits the deduction from gross income of:—

> "(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *
>
> "(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; * * *

Sec. 234(a), Sec. 212 (permitting the filing of returns on the accrual basis) and Sec. 232, are fully set forth in petitioner's brief and are not here again repeated.

Argument.

It should first be pointed out that the Revenue Act of 1918 Sec. 234(a) contains no provisions defining when an expenses or a loss is "incurred" or "sustained", so that necessarily the Courts must look to General Rules or other specific Statutes applicable to the different branches of law when such a definition is a prerequisite to a decision. In this case the Court below has given effect to a cardinal principle of the law of contracts as established by decisions, not only of the highest Courts in State Jurisdictions, but also by decisions of this Court, that damages for breach of contract *are suffered when the contract is broken* and *are assessed as of that date. Parker* v. *Russel*, 133 Mass. 74, 75; *Pierce* v. *Tenn. Coal Co.* 173 U. S. 1. That this is true is admitted by the petitioner in his brief (p. 13), but he contends that, nevertheless, the decision in this case is in conflict with decisions of the United States Court of Claims and of this Court, because, although incurred or sustained in the year of the breach, the amount of the expense or loss was not in that

year fixed at a definite sum. Such argument in behalf of petitioner is not tenable under the Revenue Act, in the light of previous departmental interpretation, or under the decisions themselves, as we will point out.

The sections of the Revenue Act of 1918 here involved, do not require that an expense or a loss incurred or sustained in any year be converted into a definite fixed amount in that year as a condition precedent to an allowable deduction, nor have such sections been so interpreted by the Courts or by the Commissioner of Internal Revenue himself. In the case of *United States* v. *Anderson,* 269 U. S. 422 (a case relied on by petitioner in his brief), this Court, referring to Treasury Decision 2433 (under the 1916 Act), which allowed a taxpayer to set up and deduct reserves to meet liabilities the "amount of which or date of maturity" was not definitely determinable, and which provided the method of readjusting such reserves when the actual amount of the liability was definitely ascertained, said (p. 438):

> "We think the Statute was correctly interpreted by the Commissioner and that his decision referred to was consistent with its purpose and intent."

The case now sought to be brought before this Court for review is not only not in conflict with this Court's decision in *United States* v. *Anderson,* but is actually in accord with and carries out the principles established therein, as the Court below pointed out in its opinion (Record, pp. 17 and 18).

The decision of the United Stats Court of Claims in *Malleable Iron Range Co.* v. *United States,* 62C, Cls. 425 and 65C, Cls. 441, with which the decision in this case is claimed to conflict, involved neither facts nor law similar to or applicable to our case. In the former case, the claimed deduction was based upon a judgment awarded for patent infringement occurring over a continuing period of six years (1905-1911). In the present case the deduction is based upon a breach of contract which occurred on a date in May, 1919. In the former case the taxpayer was not seeking to make the deduction in the year or years of the infringement, so that the

court was not called upon to apply any rules of Patent Law to determine when damages for patent infringement are "incurred" or "sustained". In our case the taxpayer did seek to make the deduction in the year in which the breach occurred, and the Court below, looking to the law of contracts for a definition of the time when damages for a breach are "incurred", found a well established principle that such damages are *"sustained when the contract is broken and are assessed as of that date"*, and applied such principle to the provisions of Sec. 234 (a) Revenue Act of 1918, in accordance with the contemplation of the whole Taxing Statute and the decision of this Court that the changes in the Taxing Statute made in 1916 were—

> "to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period;" *United States* v. *Anderson*, 269 U. S. 422 at page 440.

The Court of Claims in its first decision, had before it incomplete findings of fact, and such expressions as "when the amount in question is in litigation it cannot be determined until the litigation is ended", contained in such decision (62C Cls. 425 at p. 432), are clearly dictum in the light of the opinion rendered after the case was remanded to it by this Court for additional findings, when it was disclosed that no such question was presented. The actual decision rendered in the case (65C Cls. 441) held that a taxpayer who had accrued on its books an amount equal to the security given to cover a judgment awarded for patent infringement, was entitled to deduct such accrual *without waiting for final determination either as to the vadility or amount of the judgment* by higher courts to which appeal had been taken. Only in this latter respect are the two cases at all similar or parallel and in this respect *they are in complete accord.* This decision of the Court of Claims is also in accord with a previous decision of the Court below in

Becker Bros. v. *United States,* 7 F (2d) 3, referred to in petitioner's brief.

Counsel, in their supporting brief, refer to two further cases, a District Court decision, *Consolidated Tea Co.* v. *Bowers,* 19 F (2d) 382, and the decision of this Court in *Lewellyn* v. *Electric Reduction Co.,* 275 U. S. 243, the latter being a case chiefly relied on by the petitioner in the Court below, and discussed in the opinion below (record page 18). In the *Consolidated Tea Co.* case the deduction was based on a claim for commissions earned, reduced to judgment, and sought to be deducted, not in the year or years when the commissions were earned, but in the year when the judgment was rendered. The Court said, in its opinion, page 384:

> "It seems to me that the time of the mere rendering of a judgment is not the controlling factor in determining when a loss is sustained * * *. From a tax income standpoint, both logical and practical reasons seem to me to support the conclusion that a loss should be deductible not in the year when the judgment was rendered, but in the year when the claim was adjudicated to be final and definite, or possibly under certain circumstances in the year when the claim originated."

The case of *Lewellyn* v. *Electric Reduction Co., supra,* involved the deduction of a debt ascertained to be worthless and not damages for breach of contract, so that the decision was controlled by entirely different provisions of the Revenue Act, and has no application direct or implied to the question presented in this case. In the *Electric Reduction Co.* case, this Court held that on the facts the taxpayer had elected to treat his claim as a debt and that, therefore, it was deductible in 1922 under sub-section 5 of Sec. 234, Revenue Act of 1918, C. 18, 40 Stat. 1057, as a debt ascertained to be worthless in that year, and not in 1918 under sub-section 4 as a loss deductible when "sustained". The taxpayer had not elected to treat the purchase and sale contract under which it made prepayment, as abandoned by the seller in 1918, and had not made an accrual on its books of a 1918 loss, but had carried the prepaid amount on its books as one of its "bills

receivable" until the judgment which it ultimately recovered proved uncollectable.

The decision of the Court below does not overturn Article 111 of Regulations 45. It is strictly in accordance with its provisions that each year's return, so far as practicable, both as to income and deductions, should be complete; that the expenses, liabilities or deficit of one year cannot be used to reduce the income of a subsequent year, and that a person making returns on an accrual basis, has the right to deduct all authorized allowances, whether paid in cash or set up as a liability. It clarifies and ends the confusion which has existed over those provisions of Article 111 in which the Commissioner attempted to define, in certain specific cases, the time when a certain kind of loss or expense is incurred or sustained, a clarification, the necessity for which the Commissioner has already recognized by the change made when Article 112, Regulations 65 were promulgated.

Article 111, Reg. 45 provided:

> "* * * A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deductions therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. * * * Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. * * *".

Article 112, Reg. 65 and 69 provided:

> "* * * A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next nor any succeeding year. It is

recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. * * *".

The decision in this case creates no confusion in the administration of the income tax law, but on the contrary it effectively ends the confusion which has heretofore existed in similar cases, caused by the conflicting decisions of the Board of Tax Appeals, acquiesced in by the Commissioner of Internal Revenue, in the cases of *Appeal of Producers Fuel Co.,* 1 B. T. A. 202, and *Hidalgo Steel Co.* v. *Commissioner,* 8. B. T. A. 76. The inconsistency of these cases is fully discussed and pointed out in the opinion of the Court below (Record, p. 17).

The decision herein establishes no new or hitherto unsupported rule of law. It is in conflict with no previous decisions of this Court or of lower Courts. It applies a well established rule of Contract Law to interpret the Revenue Act of 1918 in a way which is in full conformity with the provisions of that act and with other decisions of the Courts thereunder, particularly the decision of this Court in *United States* v. *Anderson, supra.* The petition for a writ of certiorari herein should, therefore, be denied.

Respectfully submitted,

CLARK H. HEBNER,
Counsel for Respondent.

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In the Supreme Court of the United States.

OCTOBER TERM, 1929.

No. 67.

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

AMERICAN CODE COMPANY, INCORPORATED.

BRIEF FOR RESPONDENT.

The Evening Post Job Printing Office, Inc., 154 Fulton St., New York, N. Y.

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In the Supreme Court of the United States.

OCTOBER TERM, 1929

No. 67.

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

AMERICAN CODE COMPANY, INCORPORATED.

BRIEF FOR RESPONDENT.

OPINIONS BELOW.

The opinion of the United States Board of Tax Appeals (R. 7-9) is reported in 10 B. T. A. 476. That of the United States Circuit Court of Appeals for the Second Circuit (R. 14-18) is reported in 30 F. (2d) 222.

QUESTION PRESENTED.

Are damages for a Breach of Contract incurred and sustained on the date of the Breach, within the meaning of Section 234A of the Revenue Act of 1918, entitling a taxpayer, making income tax returns on the accrual basis, to take deduction therefor from income of the year in which the Breach occurred?

STATUTES INVOLVED.

This case involves the general law of contracts and Revenue Act of 1918, C. 18, 40 Stat. 1057, Secs. 234, 212 and 232.

"Sec. 234(a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

* * * * * *

Sec. 212(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

Sec. 232 That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

SUMMARY OF ARGUMENT.

Where a taxpayer commits an act in a certain tax year which gives rise to a cause of action against it for Breach of Contract, all the events have occurred from which the taxpayer's liability is to be determined and the amount thereof fixed, because damages for Breach of Contract are suffered when the contract is broken and are assessed as of that date. Therefore, such taxpayer, whose regular method of accounting is an accrual basis, authorized by Section 212(b) of the Revenue Act of 1918, is entitled to accrue a reserve to cover its liability, which reserve is an expense or loss incurred or sustained within the meaning of Section 234(a) of said Revenue Act. The happening of the events which give rise to the liability and from which the amount of it is determined, fix the year, the income of which is affected by such liability and not those subsequent circumstances, unrelated to the business of a taxpayer or to those transactions which it carries on to produce income, such as the required action of officials, Boards or Courts, in determining the liability and fixing the amount, obviously affected as to the time of occurrence by the condition of calendars, the length of time given to consideration of a case, and similar circumstances.

ARGUMENT.

A LOSS OR EXPENSE ARISING FROM A BREACH OF CONTRACT IS INCURRED ON THE DATE OF THE BREACH, IS ASSESSED AS OF THAT DATE AND, UNDER THE REVENUE ACT OF 1918, IS DEDUCTIBLE IN THAT YEAR.

Section 212 of the Revenue Act of 1918 allows a taxpayer to file returns on an accrual basis if the books are so kept, and Section 234(a) of the same act permits a corporation to deduct from its gross income—

> "(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *
>
> "(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise. * * *"

Section 234, however, contains no provisions defining when an expense or a loss is "incurred" or "sustained", so that such a definition must be supplied by the application to the Revenue Act of General Rules of Law.

The expense or loss in this case arose from a Breach of Contract which occurred in May 1919. It is a cardinal principle of the law of contracts that damages for a breach *are suffered when the Contract is broken* and *are assessed as of that date.* This principle has been established not only in most State Jurisdictions but also in the Federal Courts. *Freer* v. *Denton,* 61 N. Y. 492; *Howard* v. *Daly,* 61 N. Y. 362; *Parker* v. *Russell,* 133 Mass. 74; *Roehm* v. *Horst,* 178 U. S. 1; *Pierce* v. *Tennessee Coal Co.,* 173 U. S. 1.

The case of *Parker* v. *Russell,* cited above, has been widely cited and followed in many states and has been ap-

proved in the Federal Courts. In this case it was said (pp. 75 and 76).

> "But if the breach has been such that the plaintiff has the right to treat the contract as absolutely and finally broken by the defendant, and he elects to so treat it, the damages are assessed as of a total breach of an entire contract. *Amos* v. *Oakley,* 131 Mass. 413; *Schell* v. *Plumb,* 55 N. Y. 592 (and other cases). Such damages are not special or prospective but are the damages naturally resulting from a total breach of the contract and *are suffered when the contract is broken and are assessed as of that time."* (The italics are ours.)

In *Pierce* v. *Tennessee Coal Co., supra,* there is found an exhaustive synopsis of the application of the rule of law under discussion in various jurisdictions. The opinion contains a particularly clear discussion and approval of the decision in *Parker* v. *Russell,* and as a conclusion holds (p. 16):

> "But he had the right to elect to treat the contract as absolutely and finally broken by the defendant; to maintain this action once for all as for a total breach of the entire contract and to recover all that he should have received in the future as well as in the past if the contract had been kept. In so doing, he would simply recover the value of the contract to him at the time of breach including all the damages, past or future, resulting from the total breach of the contract."

Applying this fundamental rule of Contract Law to the Sections of the Revenue Act of 1918, we find that the amount which respondent suffered as an expense or loss by reason of its Breach of Contract in 1919, was an allowable

deduction from its income of that year, in fact, was a necessary deduction in that year for one keeping its books and making its returns on an accrual basis, in order that the return clearly reflect the true income of the year.

The petitioner in his brief, admitting the correctness of the rule that damages for a Breach of Contract are suffered when the contract is broken and are assessed as of that time, argues that such rule is wholly inapplicable here, because it has been the consistent policy of the Commissioner, approved by the Courts, to disallow any accrued deduction for a business expense or loss until all the events have occurred which fix the amount of the expense or loss. The Revenue Act itself contains no such provision, the history of the administration of the various Revenue Acts discloses no such policy of enforcement, and the Courts have not by their decisions, established any such rule, but have decided to the contrary, particularly in those cases cited in petitioner's brief.

Since 1916 the machinery set up by the Commissioner of Internal Revenue, for the interpretation and enforcement of the Revenue Acts, has always provided for the making of Income Tax returns on an accrual basis, and for adjustment of accrued items not fixed in amount at the time of accrual, by means of claims for refund or additional assessment. It was recognized that in a business of any magnitude there are bound to be items properly relating to the income of a particular year which cannot be definitely ascertained by the time fixed for the filing of the year's return. In the 1916 Act the taxing statutes were changed to allow a corporation to make its returns upon the same

basis that its accounts were kept (if kept on other than actual receipts and disbursements basis). The Commissioner then promulgated Treasury Decision 2433 to interpret this change in the statute, ruling that it—

> "will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges, to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated, income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis."

The deecision also permitted the deduction of reserves set up by a taxpayer, following a consistent accounting practice, to cover liabilities the "amount of which or date of maturity" were *not definitely determinable.*

This interpretation of the Statute by the Commissioner was approved by this Court in the case of *United States* v. *Anderson,* 269 U. S. 422, a case mainly relied on by petitioner as supporting his arguments. In this case the Court, after reciting the changes brought about by the 1916 Act and the Treasury Decision, above referred to, said:

> "We think that the statute was correctly interpreted by the Commissioner and that his decision referred to was consistent with its purpose and intent" (p. 438)

and that the purpose and intent of the 1916 Act—

> "was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis" (p. 440).

In Article 111 of Regulations 45, promulgated by the Commissioner pursuant to the Revenue Act of 1918, we find that—

> "Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return.

and

> "The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year."

and

> "A person making returns on an accrual (accrued) basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deduction therefor, he cannot deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities."

and

> "If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from the gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return."

In later Regulations the Commissioner has even more clearly recognized the right to deduct reserves to cover unliquidated liabilities.

Article 112, Reg. 65 and 69 provided:

> "* * * A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next nor any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduc-

> tion, less any amount of such damages as may have been compensated for by insurance or otherwise. * * *".

The Courts also have repeatedly held either directly or by implication from the facts involved in a particular case, that, fixation of the amount of a loss is not a necessary condition precedent to the allowance of a reserve set up to cover it, so long as the loss has been "incurred" or "sustained" by the happening of the events which give rise to the liability and which are considered in the final determination of the amount thereof. An analysis of the cases cited by petitioner shows this and establishes that such cases are as a whole authorities supporting the respondent's contentions.

In *United States* v. *Anderson, supra,* two taxpayers were involved; in one case the taxpayer had, in 1916, set up a reserve for munitions taxes. The return for the tax was made in 1917 and the tax, *after revision and an additional assessment* was paid in 1917. In the other case a reserve for such taxes was set up in 1916 in the amount of $86,541.95. In 1917 the munitions tax was returned and *ultimately assessed and paid in* the sum of $112,419.54. In both cases the taxpayers deducted the amount of the tax in their 1917 returns and the Commissioner, taking a position exactly opposite to his position in this case, sought to compel the taxpayers to take the deductions in 1916. In neither case had the amount of the tax been fixed in 1916. And in both cases the reserve set up in 1916 did not correspond to the amount of the tax ultimately assessed by the Commissioner in 1917 requiring the happening of further "events",

using the word in the sense in which it is used in petitioner's arguments, before such final determination was had, to wit, the action of the Commissioner in revising the returns and fixing the tax. Nevertheless, the Commissioner claimed that the deduction must be taken in 1916 and was upheld by this Court. The Commissioner did not claim, as he has in this case, that the act of fixing and determining the tax in 1917 was an event which made the tax relate to 1917 income instead of 1916 income. He did claim that all the events which fixed the liability, if there was any, and all the events from which the amount of the tax could be determined had occurred in 1916, and hence such tax was related to 1916 business. This Court, in effect, held that in order for an expense or loss to be deductible in a certain year, all the events must have occurred from which the liability *is to be* determined and the amount thereof fixed. This is shown not only by the facts recited in the opinion and just referred to, but also by the approval, in the language of the opinion previously quoted, of the method promulgated for setting up and deducting reserves to cover liabilities the "amount of which or date of maturity" is not definitely determinable. In the *Anderson case* would denial of liability by the taxpayer by contesting the validity of the imposition of the tax, have so changed the facts that the Commissioner, or the Court, would have allowed the deduction in 1917, when the liability and the amount were definitely fixed? We think not. The events which give rise to the liability and from which the amount of it is determined fix the year whose income is affected thereby and not the subsequent events, controlled by the condition of Court calen-

dars, the length of time given to consideration of the case by the Courts, and similar circumstances, not related in any way to the business of a taxpayer or to those transactions which he carries on to produce income in the particular year in which the final determination is made.

The position taken by the Commissioner in this case is entirely inconsistent with his position in the *Anderson case,* and he attempts to deduce from that case a rule which is not there present or laid down, and which would be contrary to the contention which he advanced therein.

In the case of *Lewellyn* v. *Electric Reduction Co.,* 275 U. S. 243, cited by petitioner as supporting his argument, the taxpayer sought to deduct in 1918 the amount which it had prepaid in that year to a seller who had contracted to deliver merchandise to the taxpayer but had failed to do so. The taxpayer had not, however, elected to treat the contract as abandoned by the seller in 1918, but had in fact endeavored to get deliveries made and had succeeded in getting some deliveries as late as December in that year. There was, therefore, no Breach of Contract occurring in 1918. When the taxpayer did finally pursue his legal remedies he did not seek to recover damages for the seller's Breach of Contract, but only sought to recover from the seller the balance of the amount prepaid. There is, therefore, no parallel between that case and the case at bar, but the Court recognized that had the taxpayer elected to treat the contract as breached in 1918 as was his right, the result might have been different. (Quoting from p. 246):

> "We may assume also that upon the abandonment of the contract by the seller the buyer might have maintained an action to recover the balance of the

money which he had paid. But so far as appears from the record there had been no abandonment by the seller in 1918. Throughout that period the buyer was calling for deliveries and some were made as late as in December. The buyer's rights were upon a contract for the delivery of merchandise and were not a "debt" in either a technical or a colloquial sense. We conclude that if respondent's contract rights became worthless in 1918 he was not required to deduct his loss as a worthless debt under sub-section (5), but was entitled to deduct it under sub-section (4) as a loss sustained in that year."

The decision of the United States Court of Claims in *Malleable Iron Range Co.* v. *United States,* 62C, Cls. 425 and 65C, Cls. 441 cited in petitioner's brief, involved neither facts nor law similar to or applicable to our case. In the former case, the claimed deduction was based upon a judgment awarded for patent infringement occurring over a continuing period of six years (1905-1911). In the present case the deduction is based upon a breach of contract which occurred on a date in May, 1919. In the former case the taxpayer was not seeking to make the deduction in the year or years of the infringement, but in the year in which the judgment was rendered by the Trial Court. In our case the taxpayer did seek to make the deduction in the year in which the breach occurred, and the Court below, looking to the law of contracts for a definition of the time when damages for a breach are "incurred", found a well established principle that such damages are *"sustained when the contract is broken and are assessed as of that date"*, and applied such principle to the provisions of Section 234(a) Revenue Act of 1918, in accordance with the

contemplation of the whole Taxing Statute and the decision of this Court that the changes in the Taxing Statute made in 1916 were—

> "to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period;" *United States* v. *Anderson,* 269 U. S. 422 at page 440.

The Court of Claims in its first decision had before it incomplete findings of fact, and such expressions as "when the amount in question is in litigation it cannot be determined until the litigation is ended", contained in such decision (62C Cls. 425 at p. 432), are contrary to this court's decision in *United States* v. *Anderson, supra,* and are clearly dictum in the light of the opinion rendered after the case was remanded to it by this Court for additional findings, when it was disclosed that no such question was presented. The actual decision rendered in the case (65C Cls. 441) held that a taxpayer who had accrued on its books an amount equal to the security given to cover a judgment awarded for patent infringement, was entitled to deduct such accrual in the year in which the security was given *without waiting for final determination either as to the validity or amount of the judgment* by higher courts to which appeal had been taken. Only in this latter respect is there any similarity with the case at bar, and in this respect there is complete accord with the principal laid down in the *Anderson case* and contended for by the respondent in this case.

Becker Bros. v. *United States,* 7 F. (2d) 3, involved similar facts and resulted in the same decision as the second *Malleable Iron Range decision.*

In *Consolidated Tea Co.* v. *Bowers,* 19 F. (2d) 382, a district court concluded that the rendering of a judgment is not the controlling factor in determining when a loss is sustained. A decision which lends support to our arguments and which is certainly not an authority for petitioner's contentions. In this case, based on a claim for commissions earned, the reserve was not made in the year or years when the commissions were earned, but was made in the year in which the judgment was rendered. This judgment was taken up on appeal and, unlike the last two cases discussed, no bond or security for the judgment was furnished. The only question presented was whether or not the deduction could be made in the year when the judgment was rendered.

The Court said in its opinion, page 384:

> "It seems to me that the time of the mere rendering of a judgment is not the controlling factor in determining when a loss is sustained * * *. From a tax income standpoint, both logical and practical reasons seem to me to support the conclusion that a loss should be deductible not in the year when the judgment was rendered, but in the year when the claim was adjudicated to be final and definite, or possibly under certain circumstances in the year when the claim originated." * * *
>
> "* * * while it is not necessary in deciding this case, and is probably inadvisable with the present record to determine whether the loss in question may have been deductible at the time the services were rendered or the damage occurred upon which the judg-

> ment against the tea company was founded, or was deductible when the judgment was affirmed and paid, I think it is clear that it was not deductible in 1919, and accordingly a verdict is directed in favor of the defendant."

As the taxpayer made no claim for right to deduct in the year when the claim arose, and as no security seems to have been given to cover the judgment, this decision is consistent with the cases previously discussed and cannot be construed as supporting petitioner's contentions. In fact the dicta in the Court's opinion is in support of respondent's arguments.

In the cases of *S. Naitove & Co.* v. *Commissioner,* 32 F. (2d) 949, and *Kaufmann Department Stores, Inc.,* 11 B. T. A. 949 (C. C. A. 3d), 34 F. (2d) 257, the facts disclose that all the events had not occurred in the year or years in which deductions were sought, from which the liability could be determined. In the former case an agreement for the payment of a bonus to certain employees provided that the amount should remain in the business for five years subject to the risks of the business and that if any employee was meanwhile discharged or withdrew from the employment his right to the bonus was to revert to the employer. It can thus be seen that the occurrence of events subsequent to any particular year affected an employee's right to a bonus or the amount which he might get. As the Court said (p. 950):

> "The accounts under the agreement were kept on the books of appellant on an accrual basis, under which system those items of expense could not accrue until all the events occurred from which liability could be determined and become fixed."

and pages 950, 951:

> "Construing the provisions of the income tax law here involved we are of the opinion that under the accrual system of accounting income may be said to be accrued when it is definitely received, and that likewise liabilities or expenses will be considered to have accrued only when the events have occurred from which liability or expense can be determined and fixed, even though payment is not yet due. This principle was involved in *United States* v. *Anderson, et al.* 269 U. S. 422."

and page 951:

> "The resolution in the present case amounts to nothing more than an offer to pay additional compensation to certain employees under a conditional contract which could only mature into an obligation and become binding upon appellant company on complete performance by its employees of the acts called for therein, and which could not be ascertained until the expiration of the five year period fixed by the agreement."

Similar facts were present in the *Kaufmann decision* in which the Board of Tax Appeals pointed out that—

> "The *Block & Kohner* and *Anderson* cases are, we think, ones in which the right to compensation has already accrued or a liability to pay has been incurred and only the enjoyment of the compensation is postponed, or the amount to be paid is subject to be cut down or possibly wiped out by later events, whereas, in the present case * * * we are of the opinion that neither the right to receive the compensation nor the liability for its payment came into existence until the termination of the contract, * * *" (p. 957).

All the cases which we have discussed are consistent with each other and with the decision of the Court below in this case. In *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243, the Court held that there was no evidence establishing a Breach of Contract in 1918, the year in which deduction was sought, and that, therefore, allowance in that year must be denied. In *Malleable Iron Range Co.* v. *United States,* 65C Cls. 441, it was held that the taxpayer, having parted with security to cover a judgment rendered, could take the deduction in the year in which the security was given, without waiting until the validity or amount of the judgment had been determined on appeal to higher Courts. In *Consolidated Tea Co.* v. *Bowers,* 19 F. (2d) 382, where the question presented involved only whether the deduction could be taken in the year when judgment was rendered (no security appearing to have been given for the judgment) it was held that the rendition of the judgment was not the controlling event but rather the affirmance thereof, or *"under certain circumstances"*, the origination of the claim. In *S. Naitove & Co.* v. *Commissioner,* 32 F. (2d) 949, and *Kaufmann Department Stores, Inc.,* 11 B. T. A. 949, while no Breach of Contract was involved it was pointed out that the contracts under which claimed deductions arose, were still pending and required further acts of performance before all events would have occurred, from which deduction could be determined and fixed. In the former case the Court, on the authority of *United States* v. *Anderson,* stated the rule to be as we have herein contended. In the latter case the distinction between it and cases such as the one here at issue was clearly pointed out. And finally, in *United States* v.

Anderson, 269 U. S. 422, it was held that a Munitions Tax had accrued in 1916 and, therefore, must be deducted from income of that year although such tax was not actually determined and fixed until after the Commissioner of Internal Revenue had acted upon and revised the tax return made in 1917, thus confirming the rule contended for herein that the year in which deduction is made is controlled by the happening of the events from which the liability is to be determined and the amount thereof fixed.

The Board of Tax Appeals and the Commissioner himself have recognized and applied the ruling for which we herein contend. Appeal of *Producers Fuel Co.,* 1 B. T. A. 202. The Commissioner acquiesced in this decision in which it was held (p. 207):

> "The taxpayer's liability for damages on account of the breach of these contracts was a liability actually incurred at the date of the breach."

In later decisions, however, the Board attempted to distinguish its previous decision and has created a confusion in the administration of the Income Tax law, which has been clarified by the decision of the Circuit Court of Appeals in this case. The inconsistencies of these decisions of the Board is fully discussed in the opinion of the Court below. (R. 17.)

There is no weight in petitioner's argument that the decision of the Court below in this case unsettles or overturns departmental practice, or would result in uncertainty and inconvenience in the Administration of the Income Tax law. We think it is matter of common knowledge that a great majority of income tax returns are revised in later

years in the light of facts then finally determined. The same absence of exact and final determination would have been present if the taxpayer in making his tax return had actually conformed to the decision as rendered in the cases cited, such as the *Anderson case,* and the *Malleable Iron Range case.* It has become the settled policy of Congress, as evidenced by its change in the 1916 Revenue Act, of the Commissioner, and of the Courts, to enact, enforce and interpret the Revenue Acts so as to have the tax ultimately based upon the year's true income in accordance with sound and safe business practices, and recognized accounting principles, regardless of whether or not the tax return itself, could, at the time when it had to be rendered, be an instrument of mathematical and factual correctness.

CONCLUSION.

The decision of the Circuit Court of Appeals gives effect to a recognized principle of contract law, is in full accordance with the provisions of the Revenue Act which it interprets, and is entirely consistent with prior applicable decisions of this Court and other Courts. It is submitted that such decision should be affirmed.

Respectfully submitted,

CLARK H. HEBNER,
Counsel for Respondent.

SUPREME COURT OF THE UNITED STATES.

No. 67.—October Term, 1929.

Robert H. Lucas, as Commissioner of Internal Revenue, Petitioner, *vs.* American Code Company, Inc.	On Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[February 24, 1930.]

Mr. Justice Brandeis delivered the opinion of the Court.

When the income-tax return for 1919, of the American Code Company, Inc., was being audited in 1925, the Company filed with the Commissioner of Internal Revenue a claim for a refund based upon its failure to deduct from its 1919 gross income the amount for which judgment was recovered against it in 1922, on a contested liability for a breach of contract in 1919. The Commissioner of Internal Revenue rejected the claim and asserted a deficiency. His ruling was sustained by the Board of Tax Appeals. 10 B. T. A. 476. Its decision was reversed by the United States Circuit Court of Appeals for the Second Circuit. 30 F. (2d) 222. We granted a writ of certiorari. 279 U. S. 832.

The facts on which the claim for the refund is based are as follows. The Company agreed to employ Farquhar as sales manager for eighteen years from January 3, 1919, the compensation to be a commission based on sales. In May, 1919, it discharged him, for alleged cause. In July, 1919, Farquhar brought suit against it in the Supreme Court of New York for wrongful discharge, claiming $100,000 damages. Affirmative defenses were interposed and liability was contested. In October, 1919, the Company notified the Commissioner of the suit and asked leave to deduct in its income-tax return an amount equal to the commissions for 1919 computed on the contract basis. Permission was refused; but the Company set up on its books, at the close of the year, a reserve equal to the amount of such commissions, $14,764.79. At the close of 1920, the amount in this reserve was increased by $32,994.09, computed on the same basis. In 1922, after a jury trial, judgment for $21,019.19 was entered in the trial court and, on appeal by the

Company, was affirmed by the Appellate Division. The Company then prosecuted a further appeal to the Court of Appeals. In 1923 the judgment was affirmed by that court and paid by the Company. The judgment having been rendered by the trial court early in 1922 before the books were closed for 1921, the reserve set up was adjusted as of the close of 1921 to the amount of the recovery, $21,019.19. That sum is claimed as the deduction for 1919.

The Company kept its books and made its income-tax returns on the accrual basis. The Revenue Act of 1918, Act of February 24, 1919, c. 18, § 234 (a), (4), 40 Stat. 1057, 1077-8, provides that in computing net income "losses sustained during the taxable year and not compensated for by insurance or otherwise" shall be allowed as deductions. Section 212 (b) provides that the net income shall be computed "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer," unless the method employed does not clearly reflect the net income. And Article 111 of Regulations No. 45, (1920 ed.), of the Bureau of Internal Revenue provides that a "person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability. . . ."

The Company's argument, sustained by the Court of Appeals, is that, since the breach of the contract occurred in 1919, all the facts which gave rise to the liability were fixed in that year; that damages must be assessed as of the date of the breach; that the loss therefore occurred in that year; and that it is immaterial that the amount of the damages was not determined or paid until later. Attention is specifically called to the provision in Article 111, which declares that if after making a return "a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return."

Generally speaking, the income-tax law is concerned only with realized losses, as with realized gains. *Weiss* v. *Wiener*, 279 U. S. 333, 335. Exception is made, however, in the case of losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduction, in certain circumstances, before they are

absolutely realized. As respects losses occasioned by the taxpayer's breach of contract, no definite legal test is provided by the statute for the determination of the year in which the loss is to be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal, test. And the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful.

Article 111 of Regulations No. 45, interpreting the provisions as to deductions for losses, states: "Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid. . . ." The Board of Tax Appeals has held, in a series of well reasoned opinions, that a loss occasioned by the taxpayer's breach of contract is not deductible in the year of the breach, except under the special circumstances where, within the tax year, there is a definite admission of liability, negotiations for settlement are begun and a reasonable estimate of the amount of the loss is accrued on the books.[1]

It may be assumed that, since the Company kept its books on the accrual basis, the mere fact that the exact amount of the lia-

[1]Appeal of Producers Fuel Co., 1 B. T. A. 202; Appeal of Brighton Mills, 1 B. T. A. 392; Appeal of New Process Cork Co., 3 B. T. A. 1339; Appeal of Bump Confectionery Co., 4 B. T. A. 50; Appeal of Hamler Coal Co., 4 B. T. A. 947; Empire Printing & Box Co. *v.* Commissioner, 5 B. T. A. 203; Appeal of Nice Ball Bearing Co., 5 B. T. A. 484, 495; Raleigh Smokeless Fuel Co. *v.* Commissioner, 6 B. T. A. 381; Farmers National Bank *v.* Commissioner, 6 B. T. A. 1036; Jewell *v.* Commissioner, 6 B. T. A. 1040; Lynchburg Colliery Co. *v.* Commissioner, 7 B. T. A. 282; Hidalgo Steel Co. *v.* Commissioner, 8 B. T. A. 76; Fraser Brick Co. *v.* Commissioner, 10 B. T. A. 1252, 1258; Safe Guard Check Writer Corporation *v.* Commissioner, 10 B. T. A. 1262; Ledbetter Manufacturing Co. *v.* Commissioner, 12 B. T. A. 145; J. G. Curtis Leather Co. *v.* Commissioner, 13 B. T. A. 1259, 1265. Compare Appeal of Lane Construction Co., 4 B. T. A. 1133; Celluloid Co. *v.* Commissioner, 9 B. T. A. 989, 1005; Graham-Bumgarner Co. *v.* Commissioner, 11 B. T. A. 603, 605; Lehigh & Hudson River Ry. Co. *v.* Commissioner, 13 B. T. A. 1154, 1164.

bility had not been definitely fixed in 1919 would not prevent the deduction, as a loss of that year, of the amount later paid. But here there are other obstacles. Obviously, the mere refusal to perform a contract does not justify the deduction, as a loss, of the anticipated damages. For, even an unquestionable breach does not result in loss, if the injured party forgives or refrains from prosecuting his claim. And, when liability is contested, the institution of a suit does not, of itself, create certainty of loss. In the few cases in which the Board of Tax Appeals has allowed a deduction in the year of the breach, the contracts, involving the purchase and sale of goods, were performable in a comparatively short period; the approximate amount of the damages was reasonably predictable; negotiations for settlement had been commenced within the year and were completed soon after its close; and the taxpayers had accrued on their books, at the end of the year, a liability reasonably estimated to equal the amount of the damages.[2]

In the case at bar, the contract had nearly eighteen more years to run, at the time of its breach. Liability for the breach was denied and strenuously contested, the litigation being carried to the highest court of the State. The amount of the damages, if any, was wholly unpredictable. While the facts determining liability had occurred in the year of the breach, the amount to be recovered, if there was legal liability, depended in large part on the course of future events. Farquhar was under a duty to mitigate damages. He might have procured new employment which would have reduced his recovery to a nominal amount. Or, recovery might have been reduced or defeated by his death. Finally, the Company did not accrue on its books, within the tax year, a liability in the estimated amount of the loss. The reserve set up had no relation to the apprehended total loss. It constituted simply the amount of the commissions which would have been payable in that year if Farquhar had remained in the Company's employ. That the Company did not intend the reserve to be an accrual of

[2]Thus, in Appeal of Producers Fuel Co., note 1 *supra*, there were two contracts for the purchase, respectively, of 15,700 and 20,000 tons of coal in equal monthly instalments between May 1920 and March 1921 and between May 1920 and May 1921. Both contracts were broken in December 1920 and offers of settlement were immediately made. Reserves of $7,500 and $30,000 were set up in 1920. The claims were settled in January 1921 for $5,500 and $29,792.40. Similar situations were involved in Raleigh Smokeless Fuel Co. *v.* Commissioner and Fraser Brick Co. *v.* Commissioner, *ibid.*

the total estimated loss is clearly indicated by the fact that, in 1920, it charged to the reserve, to cover the commissions which would have been payable in 1920, an additional amount, more than double that charged in 1919.

The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions.[3] The reserve set up by the Company was of that character. It cannot be said that the loss actually paid by the Company in 1923 was, as a matter of law or of undeniable fact, sustained in 1919. Nor did the Company so regard it. The case at bar is unlike *United States* v. *Anderson*, 269 U. S. 422. There, the liability for the munitions tax at a fixed rate on the business done in 1916 had confessedly accrued in that year and was a charge on the business of that year, although the exact amount due may not have been then ascertainable and the tax was not payable until 1917. It is also unlike *American National Co.* v. *United States*, 274 U. S. 99. There, the bonus contract provided definitely for the payment of a fixed amount. It was *debitum in praesenti, solvendum in futuro.* The case at bar is in principle more like *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

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[3]Compare Appeal of Uvalde Company, 1 B. T. A. 932; Appeal of M. C. Stockbridge, 2 B. T. A. 327; Appeal of Northwestern Bakers Supply Co., 2 B. T. A. 834; Appeal of Richmond Light & R. R. Co., 4 B. T. A. 91; Alston *v.* Commissioner, 4 B. T. A. 1159; The Davis Co. *v.* Commissioner, 6 B. T. A. 281, 283; Fibre Yarn Co. *v.* Commissioner, 10 B. T. A. 479, 480; Kaufman Department Stores, Inc. *v.* Commissioner, 11 B. T. A. 949.